The Cook Islands

2014/2015

BUDGET POLICY STATEMENT

AND

2013/2014

HALF YEAR ECONOMIC AND FISCAL UPDATE

Government of the Cook Islands

18 December 2013

www.mfem.gov.ck

Table of Contents

MINISTER OF FINANCE

GOVERNMENT OF THE COOK ISLANDS
PO Box 3246, Rarotonga, Cook Islands
Telephone + 682 24875 ♦ Facsimile + 682 24178

18 December 2013

STATEMENT OF RESPONSIBILITY

I have read the Financial Secretary's Statement of Responsibility and concur with him regarding the preparation of the 2014/15 Budget Policy Statement and the 2013/14 Half Year Economic and Fiscal Update.

To enable the Ministry of Finance and Economic Management to prepare this Budget Policy Statement and Half Year Economic and Fiscal Update, I have ensured that the Financial Secretary has been advised of all Government decisions and other circumstances as at December 2013 of which I was aware and had material economic and fiscal implications.

The 2014/15 Budget Policy Statement and the 2013/14 Half Year Economic and Fiscal Update have been produced in accordance with the *Ministry of Finance and Economic Management Act 1995/96.*

I accept the overall responsibility for the integrity of the disclosures contained in this document, and the consistency and completeness of the information in compliance with the requirements of the *Ministry of Finance and Economic Management Act 1995/96.*

Kia Manuia,

Yours Sincerely,

Honourable Mark Brown

Minister of Finance

MINISTRY OF FINANCE AND ECONOMIC MANAGEMENT

GOVERNMENT OF THE COOK ISLANDS

Office of the Financial Secretary
PO Box 120, Rarotonga, Cook Islands
Telephone + 682 22878   Facsimile + 682 23877
Email: richard.neves@cookislands.gov.ck
Web: http://www.mfem.gov.ck

18 December 2013

STATEMENT OF RESPONSIBILITY

This Budget Policy Statement (BPS) 2014/15 and Half Year Economic and Fiscal Update 2013/14 is prepared in accordance with Section 11 and 16 of the *Ministry of Finance and Economic Management Act 1995/96.* Section 11 of the Act states that the Minister of Finance shall no later than the 31^{st} day of March cause to be published a Budget Policy Statement. Section 16 further states that the Minister shall no earlier than the 1^{st} neither day of December, nor, later than the 31^{st} day of December in each financial year, cause to be published a report containing an economic and fiscal update prepared by the Ministry.

Therefore in accordance with Section 30(2) of the *Ministry of Finance and Economic Management Act 1995/96*, the Minister of Finance and the Financial Secretary shall prepare and sign a Statement of Responsibility for the financial statements.

The integrity of the disclosures and consistency with the requirements of the *Ministry of Finance and Economic Management Act 1995/96* are warranted in relation to the financial statements included within this Budget Policy Statement 2014/15 and Half Year Economic and Fiscal Update 2013/14.

The update incorporates the fiscal and economic implications both of Government decisions and circumstances as at December 2013 that were communicated to me, and of other economic and fiscal information available to the Ministry in accordance with the provisions of the *Ministry of Finance and Economic Management Act 1995/96*.

As Financial Secretary, I accept full responsibility for the integrity of the information provided.

Kia Manuia,

Richard Neves
Financial Secretary

PREFACE

The Ministry of Finance and Economic Management has published through this document both the 2014/15 Budget Policy Statement (BPS) with the 2013/14 Half Year Economic and Fiscal Update (HYEFU).

Budget Policy Statement

Section 11 of the *Ministry of Finance and Economic Management Act 1995/96* requires the Minister of Finance to publish a Budget Policy Statement (BPS) no later than 31 March in each year to come into action on 1 July of that same year. As per CM (13) 0445, Cabinet has endorsed publication of the 2014/15 BPS will be published on the 18 December 2013 to enable better aligned planning by government agencies and development partners in the 2014/15 Budget Process going forward.

The BPS states Government's policy intent for the 2014/15 fiscal year going forward including the Government's fiscal policy, its broad strategic priorities for the 2014/15 fiscal year, and any specific outputs and other expenditure that the Government anticipates to be included in the 2014/15 Budget.

Half Year Economic and Fiscal Update

Section 16 of the *Ministry of Finance and Economic Management Act 1995/96* also requires the Minister of Finance to publish a Half Year Economic and Fiscal Update (HYEFU) no earlier than 1 December and no later than 31 December in each year.

The 2013/14 HYEFU provides an update of the economic and fiscal forecasts made at the time of the 2013/14 Budget in June and provides analysis of the changes in key economic variables and their impact on the fiscal status of Government.

Given the publishing of the BPS on 18 December 2013, the HYEFU will also be published on 18 December 2013 as one document so that the reader is provided with both the Government's priorities and the context with which these priorities and policy intentions are set.

1 2013/14 BUDGET POLICY STATEMENT

1.1 Introduction

Since assuming office in November 2010, the Government has been determined in steering our country forward through the turbulent seas of global economic uncertainty. In doing so, we have made bold and strong decisions, which has restored economic growth through supporting those industries where the Cook Islands has a relative comparative advantage and maintained a sustainable fiscal policy framework.

This stance has meant that over the 2013/14 financial year, Government can add achievements with confidence to the accomplishments of the previous two years. These achievements will serve to boost the public confidence in Government's abilities to maintain and build upon stability that has clearly become evident over the past few years.

Recognising the relative comparative advantage the Cook Islands has in tourism and its place of being the key driver of our economy, the Government has continued to support the investment in underwriting long haul access to Los Angeles and Sydney. This is to ensure the economy and all those who participate in it reap the benefits from tourism. This investment has been complemented by a strong tourism growth and marketing strategy targeting a holistic approach where 'Tourism is Everybody's Business'. Furthermore, we have conducted a re-examination of the return on this investment including the provision of airline services to ensure that the most viable option is harnessed.

Returns from our marine resources have grown significantly over the past three years and continued growth is forecasted. The Government recognises clearly that utilising our marine resources must be done in a sustainable manner, hence, in the 2013/14 Budget; we have increased our spending on catch and effort data management and control of foreign fisheries in our exclusive economic zone.

With the commencement of the Seabed Minerals Act 2009 on the 1 March 2013, we have taken the cautionary approach to any future utilisation of our seabed minerals for economic growth and have begun the preparatory steps for establishing the necessary regulatory frameworks that will maintain environmental and financial integrity. This is in line with the work that has progressed in 2013, in partnership with our Aronga Mana, Te Ipukarea Society and communities to operationalise our Cook Islands Marine Park as a sustainably-managed multi-use area of our exclusive economic zone.

This year, we were threatened by the outbreak of the Oriental fruitfly on Rarotonga and Aitutaki. Recognising the potential impact of this on our economy, livelihoods and environment, the Government responded quickly to contain the threat along with the assistance of our development partners. Current observations indicate that our containment response has been successful. Failure to do so would have adversely impacted on the noticeable increase in agricultural production that has been supported by improved extension services to our growers. What risk mitigation strategies are being pursued to manage threats of this nature in future?

The Government has taken important steps to put in place the instruments that will allow for greater diversity of our economy. In this financial year, we have passed legislation that will expand the scope of the products offered by our financial services sector. We have also laid the foundation that will allow for our people to access and share the benefits derived from culture, tradition and their own innovation through the enactment of the Traditional Knowledge and Copyright acts. In addition to these statutory milestones, as we have pledged, we have continued to pursue legislative reform by enacting and amending vital legislative and the regulatory framework in the areas of finance, banking, domestic and international companies, taxation, marine resources, local governance of our islands, health, border security, energy, improving our public administration and other policy issues.

In the first major reform of our taxation system in nearly twenty years the Government will significantly shift the burden of taxation away from income earners, particularly lowly paid workers and place more emphasis on consumption tax. From 1 January 2014 workers will have more disposable income, and from 1 March 2014 welfare payments will be increased by 10 per cent and pensions by 25 per cent, to overcome price rises from the increase in the VAT, which is scheduled to increase to 15 per cent on 1 April 2014.

In the 2013/14 Budget, the Government increased spending to progress social development. After many decades of outlining issues in the levels of salaries of service delivery agents such as health practitioners, teachers and school support staff, were increased. In the health sector, the Government increased appropriation to address non-communicable diseases; boosted funding for pharmaceuticals and also for the referral of patients. A significant achievement for the 2013/14 financial year will be the re-establishment of the Cook Islands Nursing School which will commence in January 2014.

Educating our people remains high on the Government's priority list. In addition to our dual and alternative pathways learning programs, we have also endorsed the Cook Islands Tertiary Strategy and have begun implementation to ensure that our people have the opportunity to pursue formal qualifications in the post school years.

The Government also provided funding towards the Returned Services Association for the remembrance of those who have served to ensure that we enjoy the liberties that we currently do.

The Government continues to pursue improvements in the administrative and planning process of the Public Service. In November 2013, the Forum Compact Peer Review of our systems and processes was conducted in conjunction with a second Public Expenditure Financial Assessment (PEFA) which will be followed by the formal assessment in July 2014. These two reviews will identify areas of weakness in our systems and processes so that we can continue to work on strengthening and improving on the way the public service delivers and overall accountability and transparency.

The passing of the Island Government Act in February 2013 marked the commencement of a new approach towards governance in the Pa Enua. Island Councils and their communities are now empowered to determine development priorities for their respective islands. To better reflect the context of specific islands, the Government has reviewed the Pa Enua funding formula and has made the necessary adjustments for a more equitable share of resources. In addition, the Island Councils will now retain the trading revenue that they generate as an incentive to progress development objectives on their respective islands.

The Government continues to invest extensively in infrastructure that will contribute to not only economic growth but also to improving the livelihoods of our people. In this financial year, the Project City and water upgrade of the Avarua Township is currently being implemented.

The ground work for improvements to water for the remainder of Rarotonga is well underway with actual delivery commencing in 2014. This will address not only reticulation around the island, but also upgrade intakes and improve the quality of water to our people. In addition, the implementation of the water tank subsidy programme has bought relief to many households in Rarotonga. In addition to addressing water on Rarotonga, we have commenced a comprehensive water programme for the other islands. Laying the necessary foundations for delivery has been the focus in 2013 for full implementation in 2014. This will not only improve water supply and quality but also build the resilience of our communities to the adverse impacts of climate change.

Furthermore, we have completed phase one of the sanitation upgrade for Rarotonga and Aitutaki and will begin implementation of phase two in 2014; the harbours in Mauke and Mitiaro have been completed and we are in the process of climate proofing the Mangaia harbour. In renewable energy, we have begun the groundwork for the transformation of electricity supply to all six northern islands for full implementation in 2014.

To fulfil our regional obligations as well as promote our country, we have successfully hosted a number of key regional gatherings including the Pacific Islands Chief of Police Conference, Pacific Regional Triennial Meeting, SOPAC Conference, Pacific Water and Waste Association Conference and the Pacific Nansen Initiative Consultation.

The 2014/15 financial year will signal the preparations for our 50th year of self-government and as we reflect on our journey as a nation, these achievements in the 2013/14 financial year and the intentions for Budget 2014/15 will add to our reasons to celebrate together with our development partners this significant milestone of nationhood.

This Budget Policy Statement is set out in the following order:

1. 2014/2015 Budget key strategic priorities;
2. Intentions for the 2014/15 Budget; and
3. Medium Term fiscal policy.

1.2 Broad Strategic Priorities

The broad strategic priorities for Budget 2014/15 build on the achievements of the Government to date by directing public spending to encourage growth and complement private sector investment. Taking the National Sustainable Development Plan (NSDP) as a point of departure, the Government is certain that the broad strategic priorities for 2014/15 will provide a framework which protects our fiscal position and supports inclusive sustainable growth. Our broad strategic priorities are to:

1. improve the wellbeing of our people;
2. revitalise growth in the Pa Enua;

3. maximise the social and economic benefits of infrastructure investment to our communities;
4. facilitate greater income generation opportunities and economic growth in the Cook Islands;
5. take the precautionary approach to economic development ;
6. promote safety and justice; and
7. improve public service productivity.

In deciding on these priorities, Government acknowledges that there is hard work ahead in implementing these policies and doing so is in everyone interest we all gain. Our objective is inclusive sustainable growth.

1.3 Intentions for Budget 2014/15

1. Improve the wellbeing of our people

Our people are central to ensuring inclusive sustainable growth and must be active participants in our development. In addition to our bold implementation of tax reform to increase revenues at the household level, in 2014/15 we will:

- continue our investment in education with the implementation of the Education Master Plan and the Tertiary Strategy;
- continue to invest in health with the primary focus on prevention and promoting its linkages to nutrition, sports and physical activity;
- explore further options and mechanisms to ensure that those who need help the most will received appropriate support; and
- support initiatives that promote equity of opportunities for participation in the economy and society through our various grant instruments.

2. Revitalise growth in the Pa Enua

In the past the development of our Pa Enua has been mainstreamed with national development. Whilst the Government recognises that this is important from a national development planning perspective, the unique needs of the Pa Enua require a more targetted approach, with the respective Island Government's determining their development priorities and the Government and its agencies providing adequate support. This will be our focus in 2014/15. Areas of particular attention for support will be:

- growing island economies;
- improving infrastructure to support the three pillars of sustainable development;
- building resilience in our country;
- improving transportation and in particular shipping;
- improving social development outcomes; and
- to improve governance.

3. Facilitating income and economic growth

The Government has a duty to broaden opportunities for our people to participate in the economy and benefit from it. We are mindful that we have to take measures to distribute some of the benefits that arise from growth so that all our people regardless of whether they are actors in the formal or informal sectors can say that, 'this economy works for me'.

The Government wishes to accelerate its efforts in creating an environment conducive to economic growth, creation of wealth and diversifying the economy. Therefore the focus for implementation in 2014/15 will be to:

- evaluate the role the public sector plays in enabling enterprise and facilitating growth with the purpose of removing obstacles that hinder innovation and entrepreneurship;
- harness our rich cultural heritage, vibrant arts and untapped creative potential;
- encourage public private partnerships where appropriate;
- concentrate efforts on supporting our people who are starting and growing businesses;
- continue to modify regulatory frameworks that stifle business and growth;
- implement a holistic tourism growth and marketing strategy that includes all islands in the Pa Enua;
- continue to support initiatives that will diversify our economic base by increasing productivity and encouraging innovation in financial services, marine resources, agriculture and the knowledge economy;
- continue to engage in changes to improve the telecommunications sector which will accelerate economic and social development and connectivity;
- continue the implementation of the reform to tax policy targeting a more equitable distribution of wealth, increasing the disposable income at the household level and shifting the burden of taxation; and
- review our land tenure arrangements to find opportunities and enabling mechanisms that will support Cook Islanders as landowners in adding economic, social and environmental value to the use of land.

4. Maximise the social and economic benefits of infrastructure investment to our communities

The Government has made significant investments in infrastructure and has laid the foundation for continuation and actual rollout of development in 2014. To ensure resilience, our investments in infrastructure will take into take into consideration disaster risk mitigation and climate change implications. Therefore focus in infrastructure development will be to:

- implement the second stage of the sanitation programme;
- continue implementation of Te Mato Vai programme in consultation with stakeholders in Rarotonga;
- continue the strengthening resilience of our island communities through improving water resources and the small grants fund;
- improve road infrastructure in connection to the implementation of water programmes;

- continue with the implementation of Project City;
- continue with the development of infrastructure to support tourism growth, social interaction and natural environment management;
- upgrade the harbours in Manihiki and Rakahanga;
- continue the roll out of our renewable energy programme in Rarotonga and the northern group islands with a target of completion in the first half of the 2014/15 and commence implementation in the rest of the southern islands thereafter; and
- improve the capacity of our local contractors to participate in the implementation of major public infrastructure projects.

The Government acknowledges that its agencies must be better coordinated to deliver on infrastructure development. In this regard, the Government will complete the revision of the Infrastructure Master Plan launched in 2007 and launch the Infrastructure Investment Plan which will outline the roll out of public infrastructure for the medium to long term. Furthermore, we will support the up skilling and capacity building of our people in the infrastructure sector and will foster the training of local counterparts in the development and management of our public assets.

5. Taking the Precautionary Approach to economic development

The fundamental question of 'how do we best manage and maximise our natural resources to benefit our people and economy in the long run' must always be considered in the development process. In this regard, the 2014/15 financial year will be one of taking stock of the value of our natural resources and tailoring our development to reflect present and future values with the objective of integrated sustainable development. This will ensure that there is a balance between the economic, social and environment pillars of our progress.

Therefore in 2014/15, we will:

- determine the value of our natural resources through strengthening information and data collection, analysis and dissemination;
- complete our state of the environment assessment;
- continue on the work required to operationalise our Cook Islands Marine Park;
- explore options to incentivise the growth of eco-friendly and green initiatives, industries and businesses; and
- explore options of sustainable financing for conservation and environment management.

6. Promote Safety and Justice

The recent burglaries, thefts, fires, drug offences and so forth have highlighted safety and justice as critical issues requiring the attention of not only Government but also the private sector and our communities. Curbing these occurrences requires a collaborative approach and Government's will strengthen its collaboration with all stakeholders. Government recognises its duty to ensure safety. Therefore in 2014/15, Government will:

- enhance the development of strategic police and community partnerships and the implementation of smarter crime prevention initiatives to address crimes of concern;
- strengthen the investigative capacity of the Police to ensure that those who have committed crimes will be brought to justice; and
- improve the efficiency of the justice system to deal with perpetrators

The Government will continue to pursue legislative reform to modernise and fill gaps in our judicial system.

7. Improve public service productivity

Government will continue to improve the performance of the public service with an emphasis on increased productivity, better use of existing resources and shifts in the composition of spending rather than raising overall expenditure. In 2014/15, Government will:

- establish better human resource development and management frameworks across the public sector
- implement the recommendations of the Public Expenditure Financial Accountability review;
- continue to consolidate administrative functions where appropriate;
- implement a more effective performance management system;
- reduce the cost of public administration; and
- improve information management, sharing and dissemination.

1.4 Medium Term Fiscal Policy

The *Ministry of Finance and Economic Management Act 1995/96* ("the Act") requires Government to state or reaffirm its long-term objectives for fiscal policy in the annual Budget Policy Statement.

Part III Section 23(2) of the Act sets out the long term fiscal principles to ensure a positive macroeconomic environment for the Cook Islands. These principles as set out in the Act are as follows:

Ensuring that unless Crown debt is at prudent levels, operating expenses will be less than operating revenues (i.e. Government will run an operating surplus).

- Achieving and maintaining levels of Crown net worth that provide a buffer against factors which may impact adversely on net worth in the future.
- Managing prudently the fiscal risks facing the Crown.
- Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

Government must pursue its policy objectives within the financial context established by these principles which are quantified in fiscal responsibility ratios (FRR). The FRR are regularly reviewed and establish the parameters for the Budget, with a continued focus on the level of expenditure on Crown debt. These are outlined clearly in the 2013/14 Half Year Economic and Fiscal Update (HYEFU). The

2014/15 Budget will operate under tight fiscal conditions, with a need to prioritise competing policy objectives.

1.5 Conclusion

Implementing these policies with Budget 2014/15 are critical steps towards more inclusive sustainable growth. Inclusive sustainable growth calls for greater cooperation and alignment between labour, business, government, civil society, communities and our development partners to get things done. This means hearing each other out, finding solutions, encouraging innovation, building a sustainable Cook Islands.

2 ECONOMIC UPDATE

2.1 Introduction

The Cook Islands is a small open economy that is largely dependent on tourism. Consumer preferences and economic growth in our major tourist source market of New Zealand (and to a lesser extent, Australia) has a major impact on domestic economic performance. Any international developments affecting New Zealand will eventually impact on the Cook Islands. Not only is New Zealand our largest trading partner and source of tourism, but changes in the New Zealand dollar will also impact our domestic markets.

The reliance on imports to support local consumption makes the Cook Islands extremely vulnerable to external price shocks – particularly in regards to fuel as transport costs affect the price of almost all goods. Despite this, the Cook Islands enjoys a large current account surplus, owing to the significant contribution of tourism (which is counted as an exported service).

The dependency on tourism has benefitted the Cook Islands greatly, but a lack of economic diversity or economies of scale make any progress fragile and reversible, and labour market constraints across multiple areas of the economy still present major limitations on economic growth.

Global recovery from the 2008 economic crisis continues. Emerging economies still lead the recovery, but their growth has slowed more than expected, and may experience rapid capital outflows as more advanced economies recover. The Euro area (as a whole) is out of recession but remains sluggish, while the US recovery seems likely to continue in the near term.

Both the International Monetary Fund (IMF) and OECD have revised their forecasts of global economic growth to between 2.7 and 2.9 per cent in 2013, and 3.6 per cent in 2014. The ten-year average for world economic growth is 3.4 per cent growth a year.

The most recent official economic growth forecasts for 2013/14 for New Zealand and Australia are 3.2 per cent and 2½ per cent respectively. Continued economic growth in these markets should have positive flow on effects for tourism arrivals. However, with unemployment at relatively low levels in New Zealand and Australia (5.7 per cent and 6¼ per cent respectively), it is likely that employment growth in these economies will continue to entice Cook Islanders to migrate.

Since the 2013/14 Budget, tourism arrivals have fallen marginally short of forecasts. While the growth prospects for the Cook Islands remains positive in the short term, there has been a slight downward revision to both tourism and GDP estimates. The delayed implementation of aid projects, notably water and renewable energy, are the main risks to the economy outside of tourism arrivals. Offsetting this somewhat are the economic gains of the Cook Islands Government 2013 Tax Review, which adds significantly to gross domestic product (GDP) in 2014/15, but also adds to GDP in the last quarters of 2013/14.

Nominal GDP (which includes inflation) is estimated to have grown at 3.7 per cent in 2012/13, short of the 5.7 per cent initially forecast. This was estimated to have been due to weaker than expected tourism arrivals growth. Nominal growth is expected to recover in to 5.0 per cent in 2013/14, due largely to the major water and renewable energy projects and the implementation of the Tax Review offsetting a slight slowing in tourism growth. Growth falls to 2.3 per cent in 2014/15 and 0.6 per cent in 2015/16 due to a significant reduction in the aid profile in those years.

Tourist growth has been revised down from the forecasts at the 2013/14 Budget, with this taking some pressure of the capacity constraints that were expected to reduce growth from 2016 onwards. Growth in visitor arrivals is expected to fall from 3.5 per cent in 2012/13 to 2.6 per cent growth in 2013/14 due mainly to a slower growth out of New Zealand and Australia.

Inflation, as measured by the Cook Islands Consumer Price Index (CPI) was 2.6 per cent in 2012/13, slightly higher than expected, although CPI from September 2012 to September 2013 was only 1.5 per cent through the year. With the exception of the once-off increase in the VAT on 1 April 2014, inflation is expected to adjust towards its long-term trend. The CPI is forecast to increase 4.6 per cent in 2013/14 due to the change in VAT, before falling to 2.9 per cent in 2014/15.

Table 2.1: Summary of Economic Indicators

Economic Indicators	2011/2012 *Actual*	2012/2013 *Estimate*	2013/2014 *Projected*	2014/2015 *Projected*	2015/2016 *Projected*	2016/2017 *Projected*
Economic Activity						
Nominal GDP ($'000)	370,909	384,764	404,179	413,467	415,946	430,488
Percentage change (YOY)	3.5	3.7	5.0	2.3	0.6	3.5
Real GDP (at Constant 2006 Prices, $'000)	319,728	323,259	324,766	322,821	315,083	316,385
Percentage change (YOY)	0.7	1.1	0.5	-0.6	-2.4	0.4
Inflation						
Consumer Price Index (base Dec. 2006 = 100)	121.7	124.9	130.6	134.4	138.5	142.8
Percentage change (YOY)	2.8	2.6	4.6	2.9	3.1	3.1
Construction/Capital Investment						
Commercial Building Approvals ($'000)	2,975	1,859	1,859	1,859	1,859	1,859
Residential Building Approvals ($'000)	5,887	6,161	5,495	4,901	4,371	3,898
Public Works ($'000) (includes Dev Partners)	34,011	23,847	33,116	23,340	12,488	-
Productive Sector Indicators						
Visitor Arrivals	116,639	120,700	123,800	127,200	130,800	134,100
Percentage change (YOY)	7.3	3.5	2.6	2.7	2.8	2.5
Estimated Visitor Expenditures ($'000)	208,432	221,200	236,600	250,300	265,300	280,300
Pearl Exports ($'000)	639	550	550	550	550	550
Fish Exports ($'000)	3,105	2,564	2,560	2,560	2,560	2,560
External Sector						
Merchandise Trade Balance ($'000)	(138,075)	(138,193)	(138,600)	(139,400)	(140,400)	(140,400)
Services Trade Balance ($'000)	208,432	221,200	236,600	250,300	265,300	280,300
Exchange Rate (USD/NZD Average, March 2013)	0.757	0.805	0.822	0.830	0.830	0.830
Financial Sector (at end of financial year)						
Government Net Debt Position ($'000)	16,178	58,244	71,703	75,444	60,833	41,241
Private and Public Enterprise Deposits ($'000)	191,974	228,949	-	-	-	-
Private and Public Enterprise Loans ($'000)	286,213	280,364	-	-	-	-

2.2 Gross Domestic Product (GDP)

The Cook Islands economy grew a nominal 4.7 per cent in 2012 calendar year. Real GDP growth (taking into account changes in price) was 4.4 per cent in 2012, a significant improvement from the 1.0 per cent real GDP growth experienced in 2011.

Tourist arrivals in 2012 were significantly above trend levels, with growth slowing in the early months of 2013. As allowed for in one of the sensitivity analysis scenarios produced at 2013/14 Budget, the early softness in 2013 visitor arrivals continued for the remaining months of 2013. Reflecting this, nominal GDP forecasts for 2012/13 have been revised down from 5.7 per cent to an estimated 3.7 per cent.

Nominal GDP growth is then estimated to recover to 5.0 per cent in 2013/14 due to water and renewable energy projects commencing construction activity and the implementation of the Tax Review recommendations from 1 January 2014. By 2014/15, continued tourism growth and a positive contribution made by the full implementation of the Tax Review are partially offset by a rephasing in aid commitments. Consequently, nominal GDP growth is estimated to slow to 2.3 per cent in 2014/15 and 0.6 per cent in 2015/16 due largely to the large reduction in the aid profile.

Table 2.2 GDP growth revisions

	2012/13		2013/14		2014/15	
	2013/14 Budget	**2014/15 BPS**	**2013/14 Budget**	**2014/15 BPS**	**2013/14 Budget**	**2014/15 BPS**
Nominal GDP growth (per cent)	5.7	3.7	4.6	5.0	1.6	2.3
Real GDP growth (per cent)	3.2	1.1	1.8	0.5	-1.4	-0.6

Real GDP is forecasted to follow a similar pattern to nominal growth but is lower as it takes inflation into account. Real GDP growth is predicted to slow from the 2.7 per cent experienced in 2011/12 to an estimated 1.1 per cent in 2012/13, a downward revision from the 3.2 per cent predicted at the 2013/14 Budget. This slowing is predicted to continue in the outer years, with real growth continuing to slow to 0.4 per cent in 2013/14 before declining 0.5 per cent in 2014/15 and a further 2.3 per cent in 2015/16.[1]

These forecasts are dependent on a number of recent trends continuing. The key risks to GDP growth are:

[1] It is important to note here that the estimates for real GDP use the consumer price index (CPI) to deflate the nominal GDP forecasts. Historically, the GDP deflator and the CPI series have similar long-term averages (around 3.6 per cent and 3.1 per cent respectively), however, there are substantial annual differences between the two. For example, the nominal GDP growth estimate for 2012 was 4.7 per cent, while the real GDP growth was estimated at 4.4 per cent. This suggests a GDP deflator of around 0.3 per cent, whereas CPI for the same period of time was 3.0 per cent – a substantial difference. The GDP deflator is not currently forecast as quarterly estimates are unavailable.

- the preferences of New Zealand and Australian tourists moving towards other competing tourism markets in the Pacific or Asia (for example recent openings for direct flights to Bali and Honolulu from Auckland);
- an economic slowdown in New Zealand and/or Australia;
- poor budget execution of the substantial aid and capital projects planned across the Cook Islands – in particular, any delays in the implantation or the renewable energy or water projects;
- domestic labour market failing to increase through a decline in migrant labour entering the Cook Islands to fill job vacancies, or Cook Islanders continuing to leave the local market;
- external price shocks to our major import categories (fuel or food supplied by New Zealand); and
- any reductions in projected aid from development partners.

Chart 2.1: Real GDP at 2006/07 prices, 2002/03 to 2016/17 ('000)

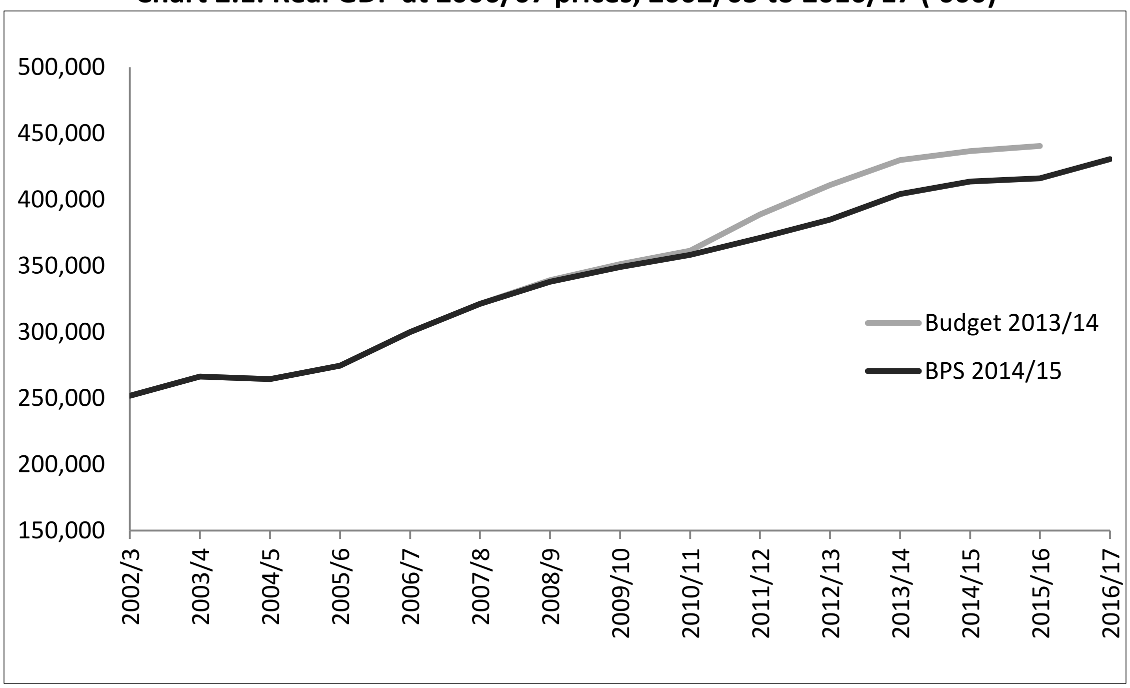


Chart 2.2: Nominal GDP at current prices, 2002/03 to 2016/17 ('000)

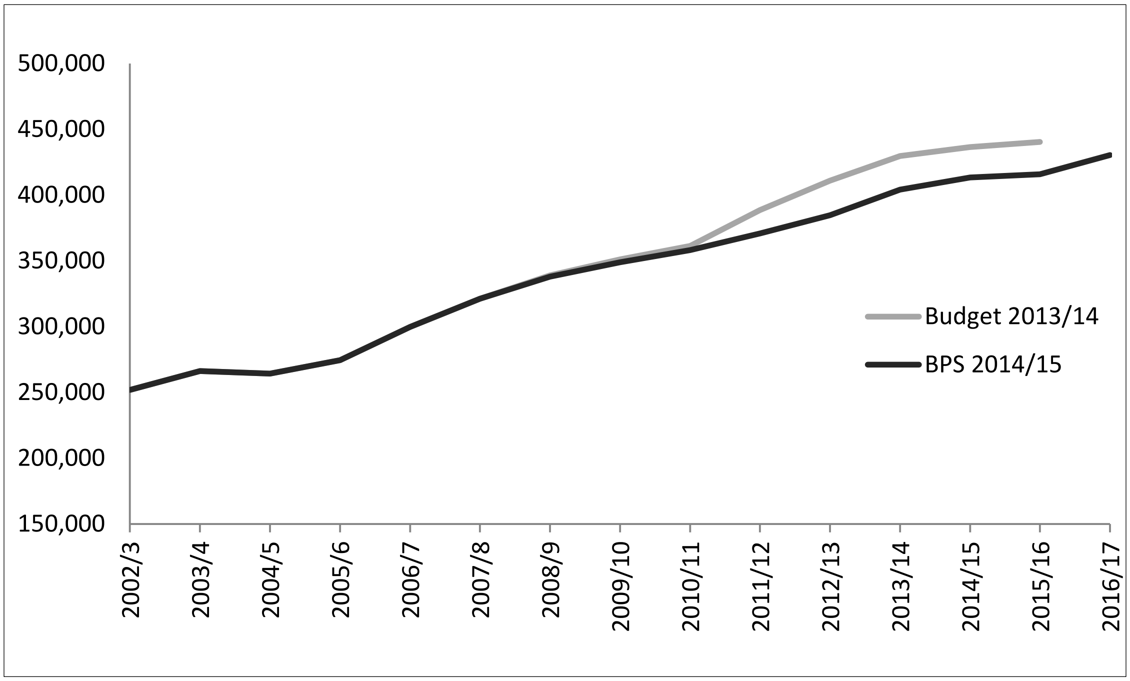
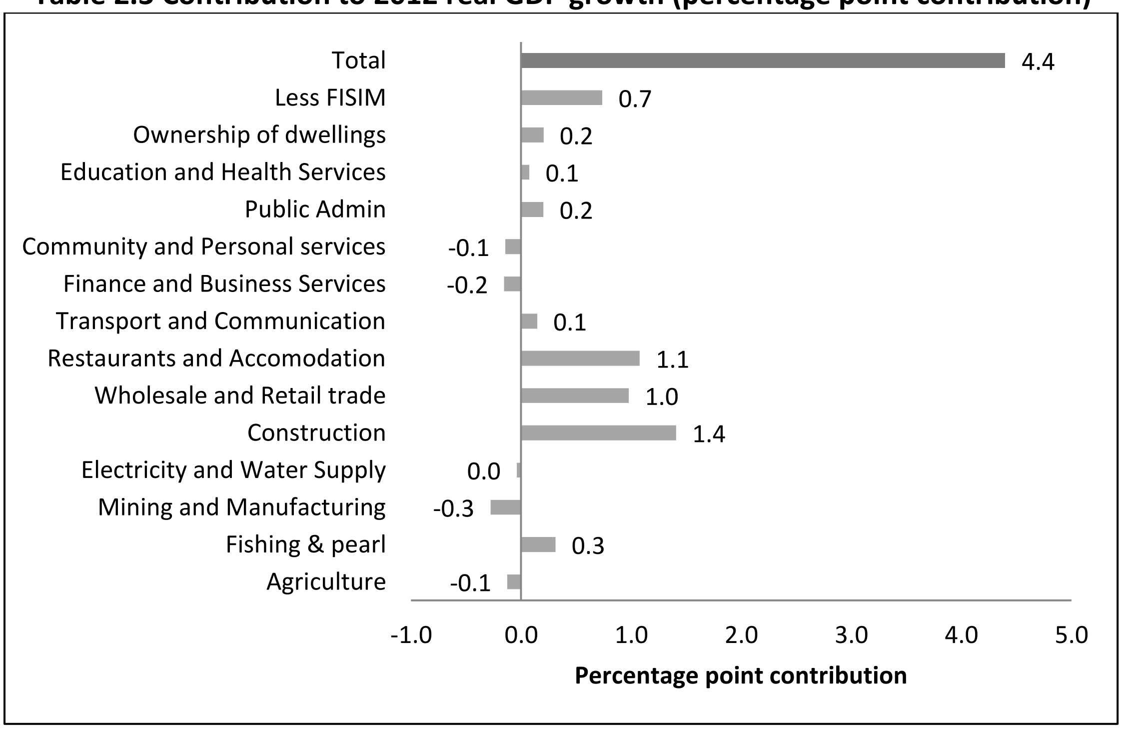


Table 2.3 Contribution to 2012 real GDP growth (percentage point contribution)



2.3 Consumer Price Index (CPI)

Inflation in the Cook Islands is measured by the Consumer Price Index (CPI) which is reported on a quarterly basis. Over the last ten years, the Cook Islands has enjoyed low and relatively stable inflation due to the use of the New Zealand dollar as the national currency, with the exception of the dramatic increase in fuel global prices which drove inflation to 10.2 per cent in 2008/09.

At the time of publication the most recent CPI data available was for the September quarter 2013, which showed inflation of 1.5 per cent compared to the September quarter 2012, and average annual inflation of 2.2 per cent for the 12 months to September.

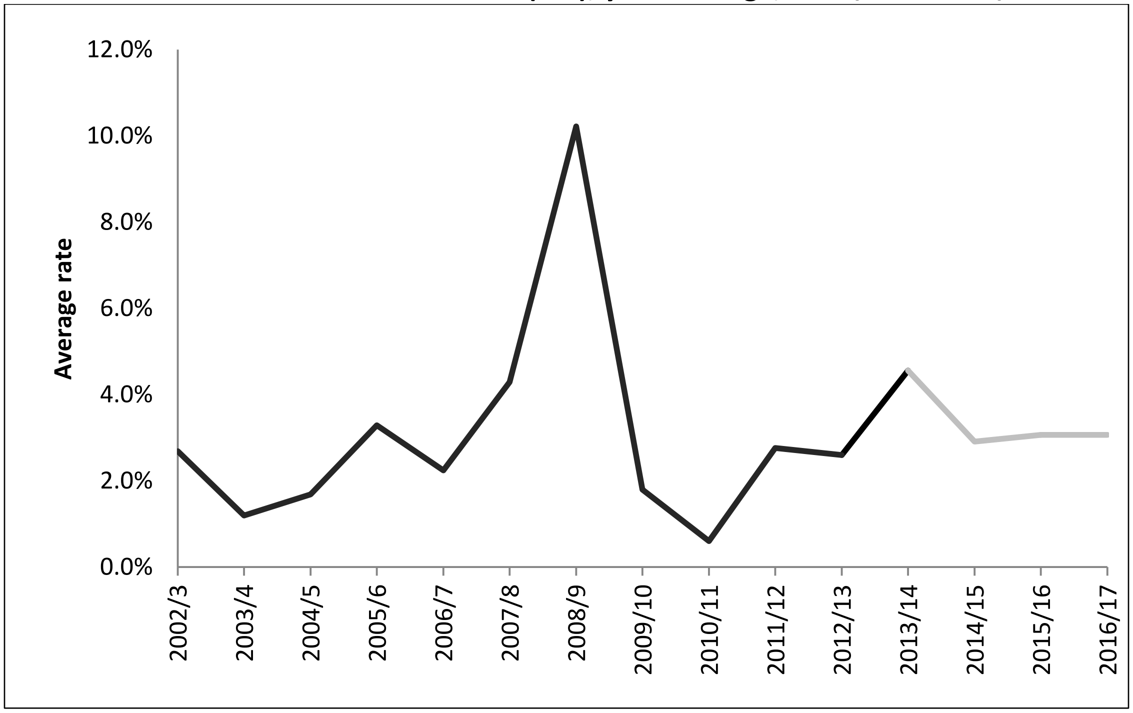
Annual inflation in the September quarter 2013 was driven by a 33.0 per cent increase in tobacco prices (contributing 1.0 percentage points to overall inflation) and a 2.6 per cent increase in food prices (contributing 0.8 percentage points) being partially offset by 10.3 per cent decrease in the cost of overseas travel (subtracting 0.5 percentage points).

As Chart 2.3 demonstrates, inflation is assumed to increase from an annual rate of 2.6 per cent in 2012/13 to its historical average of 3.1 per cent in the outer years; slightly higher than the New Zealand target rate. The exception to this is 2013/14, which will bear the full inflationary effect of the Tax Review increase to the VAT from 1 April 2014.

There are substantial risks surrounding these forecasts. A decline in the New Zealand dollar from its historic highs, would be expected to have an inflationary impact on the Cook Island economy through higher import prices. Similarly, fuel prices have remained relatively stable in recent times, and any increase from current prices could have a dramatic effect on the prices of all imported goods, which make up the bulk of consumer items (as occurred in 2007/08 and 2008/09).

On the upside, recent quarterly inflation figures have been well below average both in the Cook Islands and New Zealand. If this were to continue, inflationary pressure on the economy may be much less than anticipated over 2013/14 and 2014/15.

Chart 2.3: Consumer Price Index (CPI), year average, 2002/03 – 2016/17



2.4 Tourism

Tourism remains the largest industry in the Cook Islands, accounting for around 60 per cent of the economy (and growing). As predicted at the time of the Budget in June, the strong growth of 7.6 per cent in arrivals in calendar year 2012 was not maintained, with total arrivals in 2013 roughly unchanged from the levels seen in October last year. Further to this, tourist arrival forecasts have been further revised downwards. The strong growth experienced from New Zealand and Australian markets likely peaked over 2010 to 2012, and a return to double digit growth in the near term appears unlikely.

Reflecting ongoing softness in these key markets since January, growth in tourist arrivals is forecast to slow to 2.6 per cent in 2013/14 and 2.7 per cent in 2014/15. This is a significant downward revision from the Budget estimates of 5.7 per cent and 4.8 per cent forecast for 2013/14 and 2014/15 respectively.

Despite the slower than expected growth in 2013, New Zealand remains by far the largest market (67 per cent) and has a slightly increasing share of total arrivals. New Zealand is also the largest contributor to overall tourist growth.

Australia has a smaller, but similarly increasing share (18 per cent, up 2 per cent points in the last three years) which is offsetting the declines experienced in European and North American markets.

Chart 2.4 Total visitor arrivals (12 month moving average) 2004-2016

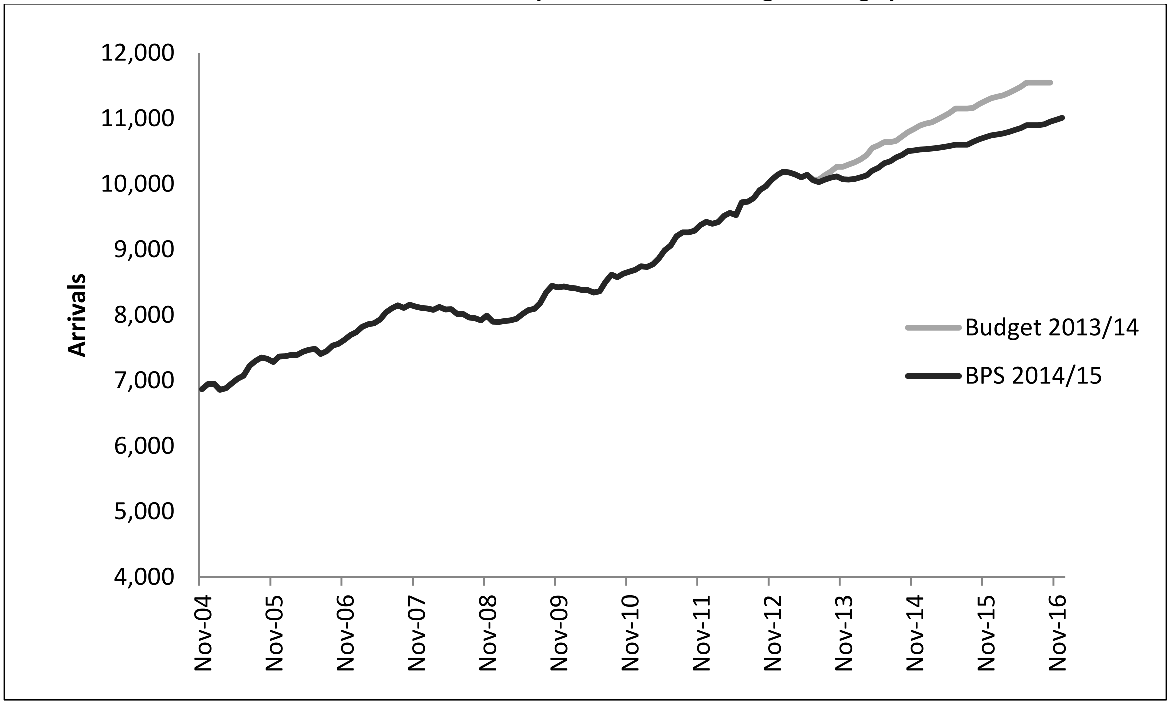


Table 2.4 Actual and forecast total tourism numbers by quarter 2012/13 to 2016/17

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Total
2012/13	38,543	31,719	20,618	29,811	120,691
2013/14	39,031	31,346	21,400	32,000	123,800
2014/15	40,500	32,300	21,700	32,600	127,200
2015/16	41,100	33,500	22,300	33,900	130,800
2016/17	41,300	34,700	23,000	35,100	134,100

It was evident in the lead up to the Pacific Island Leaders Forum in July/August 2012, which led to a record number of arrivals, that capacity constraints are now an issue in Rarotonga. July 2012 is now the yardstick for how many arrivals Rarotonga can be expected to reasonably handle. While July 2013 did not experience such marked constraints as July 2012, future periods may face the prospect of an increasing lack in overall capacity during peak periods. While some new accommodation will be forthcoming over the next year or so, additional private investment will be required to sustain industry growth during the peak months, although the downward revision in tourism forecasts has relieved this pressure somewhat.

Table 2.5 Rising capacity utilisation of Cook Islands tourism sector, 2010/11 – 2016/17

Year	Average capacity	Months with arrivals of between... 80-90 per cent	90-94 per cent	95-98 per cent	99-100 per cent	Estimated lost arrivals
2010/11	65.9 per cent	2	0	0	0	
2011/12	70.6 per cent	1	1	1	0	
2012/13	73.6 per cent	3	1	0	1	
2013/14	75.0 per cent	2	1	2	0	
2014/15	77.0 per cent	1	2	0	2	1197
2015/16	79.2 per cent	0	1	2	2	2308
2016/17	81.2 per cent	1	1	1	3	3766

Due to the downward revision in the arrival forecasts, instead of average capacity of 80 per cent being achieved in 2014/15 it is now expected to occur two years later, in 2016/17. This will hopefully give more time for new investments to come on line. However, as before, two months (July and August) are at full capacity from 2014/15 onwards, with an additional month (June) also reaching full capacity by 2016/17.

By 2014/15, it is expected that one third of the year will be experiencing occupancy rates exceeding 90 per cent. This suggests that the capacity of the tourism sector (be it management capacity or additional capital investment) needs to expand if arrivals are expected to continue during these months. An alternative strategy could also be to increase the quality of service delivery, which will also require a large amount of private investment to realise any potential gains. The tourism strategy of expanding arrivals in the 'shoulder' months is a prudent course of action in the meantime and the continued underwriting of the Sydney and LA direct flights may feed into this.

2.5 Major Markets

2.5.1 New Zealand

New Zealand continues to be the Cook Islands leading market for visitors, accounting for an estimated 67 per cent of the total market (or an estimated 82,800) in 2013/14. After growing by 3.1 per cent in 2012/13, New Zealand arrivals are expected to grow by 3.6 per cent in 2013/14. Growth is forecast to return to lower trend growth of 4.4 per cent by 2014/15.

Chart 2.5 New Zealand visitor arrivals (12 month moving average) 2004-2016

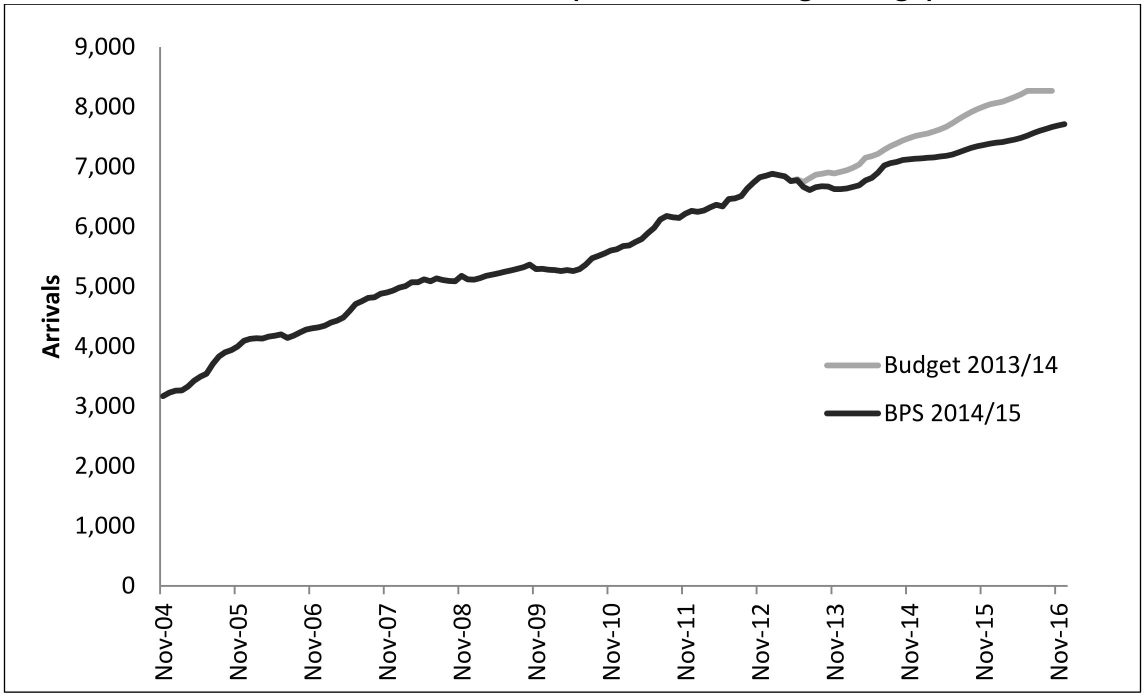


Table 2.6 Actual and forecast New Zealand tourism numbers by quarter 2012/13 to 2016/17

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Total
2012/13	28,282	20,046	11,420	20,219	79,967
2013/14	28,382	19,503	12,200	22,800	82,800
2014/15	30,500	20,200	12,500	23,300	86,400
2015/16	31,800	21,000	13,000	24,300	90,200
2016/17	33,200	22,000	13,600	25,400	94,100

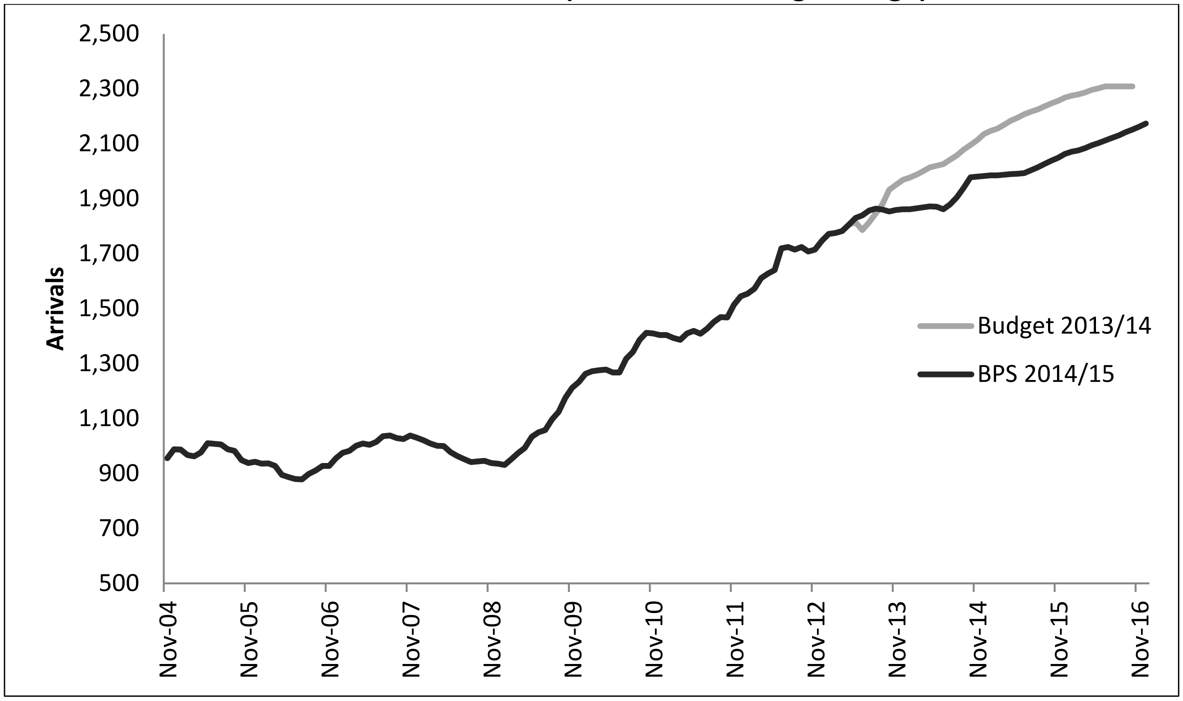
2.5.2 Australia

The Australian market is the second largest tourism market to the Cook Islands, accounting for approximately 18 per cent of the total market share of visitors to the Cook Islands. After growing an impressive 7.0 per cent in 2012/13, Australian arrivals have slowed significantly since July 2013. As most of the Australian arrivals occur in the first two quarters of the financial year (July to December) it is expected that growth in Australian arrivals will slow to around 1.2 per cent in 2013/14.

Growth is then expected to return to 7.0 per cent in 2014/15 before slowing to 6.0 per cent in 2015/16 and 4.9 per cent in 2016/17.

These are conservative forecasts. The assumption that the relatively poor performance in the early months of 2013/14 will continue into the remainder of the year, may not occur. If the Australian market recovers after the January low period to its previous growth rates, then these forecasts may need to be revised upwards in the 2014/15 Budget.

Chart 2.6 Australia visitor arrivals (12 month moving average) 2004-2016



Total arrivals from the Australian market are expected to increase from 22,074 in 2012/13 to 22,300 in 2013/14, a downward revision from the 24,300 estimated at the 2013/14 Budget reflecting lower growth outcomes.

Table 2.7 Actual and forecast Australian tourism numbers by quarter 2012/13 to 2016/17

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Total
2011/12	5,751	6,338	3,698	4,838	20,625
2012/13	5,815	6,622	4,107	5,530	22,074
2013/14	6,064	6,636	4,200	5,400	22,300
2014/15	7,000	7,200	4,200	5,500	23,900
2015/16	7,400	7,600	4,500	5,800	25,300

2.5.3 Other major markets

Outside of the two major markets, growth in tourist arrivals remains relatively weak. The European market has continued to decline from the historic high in 2000/01, while the North American markets have been relatively flat for the last five years. Asia and other markets remain relatively minor contributors.

Arrivals from other major markets grew 0.3 per cent in 2012/13, a relative ‘pause’ in an otherwise declining trend of arrivals (due almost entirely to falls in European arrivals). These markets are expected to fall a further 3.8 per cent in 2013/14, driven by European arrivals, with their declining market share being substituted by Australians. European arrivals are expected to fall to 8,200 in 2013/14 (a 6.9 per cent decline from the estimated outcome for 2012/13) with US arrivals expected to grow to 4,700 (growth of 2.2 per cent from 2012/13, which will bring US arrivals onto a similar level as in 2010/11).

The expected growth in US arrivals is an upward revision from the forecasts during the 2013/14 Budget (which were used by Covec Economics when they did their evaluation of the underwritten routes), and may contribute to a reduction in the cost of the underwritten flight from Los Angeles.

Chart 2.7 Other major markets (12 month moving average) 2004-2016

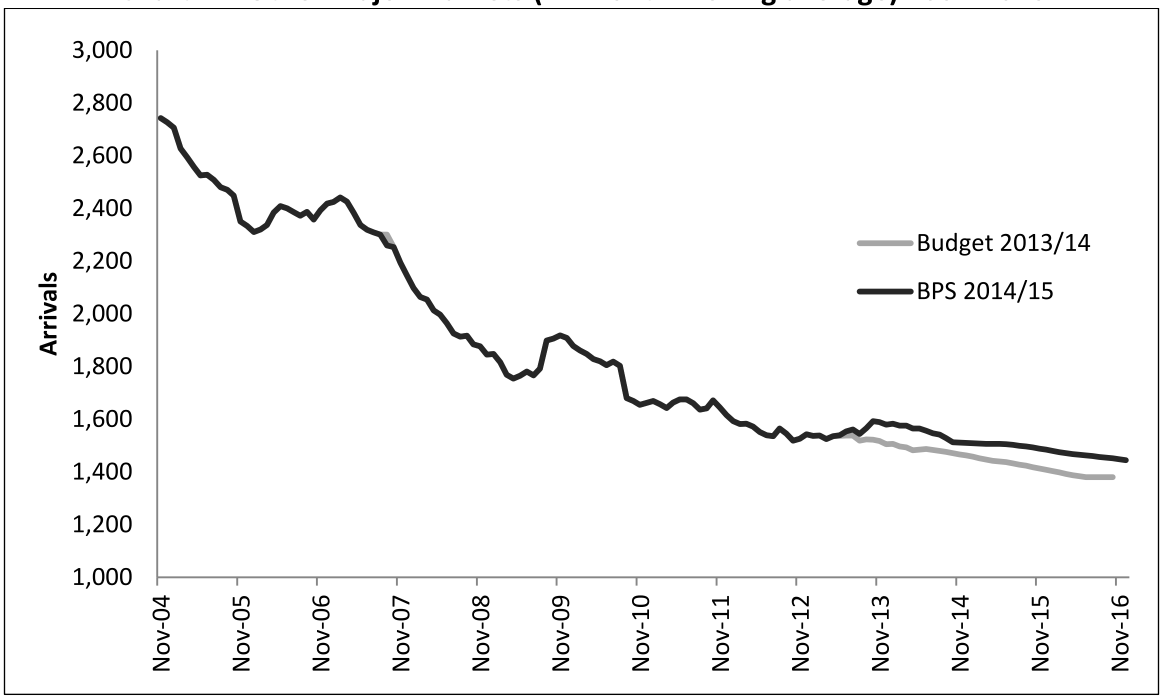


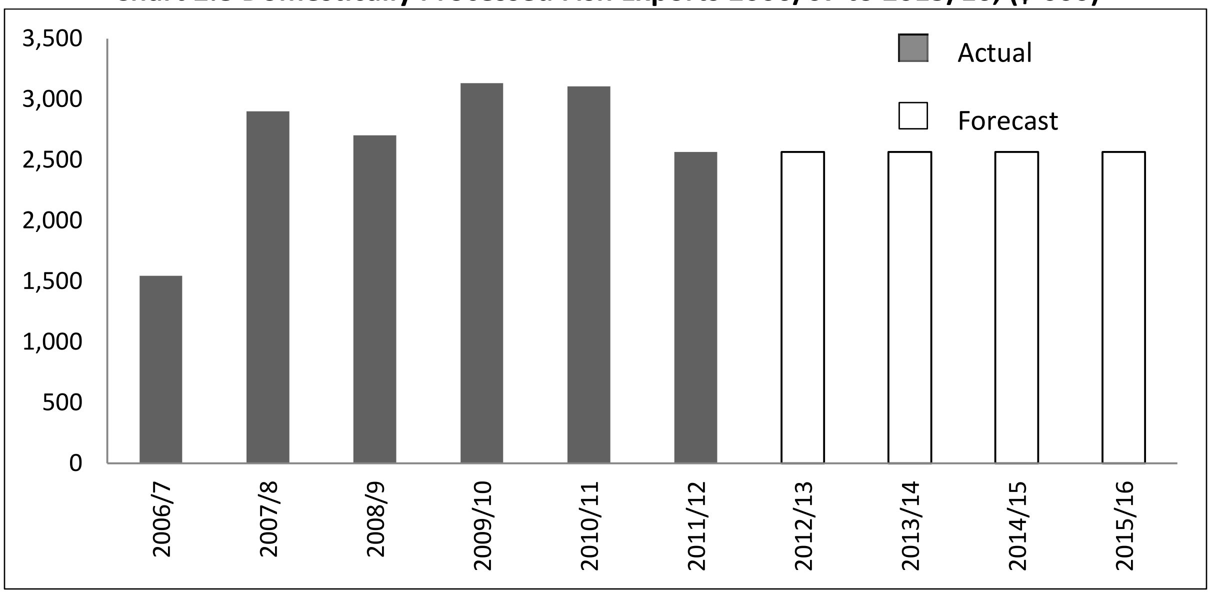
Table 2.8 Actual and forecast of tourism numbers by quarter 2012/13 to 2016/17

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Total
2012/13	4,446	5,051	5,091	4,062	18,650
2013/14	4,585	5,207	5,000	3,800	18,700
2014/15	4,300	5,000	5,000	3,800	18,100
2015/16	4,100	4,800	4,800	3,700	17,500
2016/17	4,000	4,700	4,700	3,600	17,100

2.6 Marine Resources

The Cook Islands marine sector continues to predominantly be made up of the tuna and albacore fisheries and black pearls. The total value of marine exports for 2011/12 was $3.1 million, a 16.8 per cent fall from 2010/11.Going forward, the exports from the marine sector are expected to stay relatively flat, with most of the Cook Islands catch being processed offshore. The main economic benefit derived from fishing activities continues to be the revenue received by the Ministry of Marine Resources from treaties and fishing licenses – estimated at $4.9 million in 2013/14.

Chart 2.8 Domestically Processed Fish Exports 2006/07 to 2015/16, ($'000)



2.6.1 Fishing

The Cook Islands EEZ is divided into a northern and southern fishery. The majority of fishing takes place in the northern fishery where the waters are more stable and productive. The main fishing grounds are from Penrhyn in the east, to Pukapuka in the west, and south of Suwarrow.

Since 2002 the main fishery has been long lining for albacore tuna which is offloaded frozen to the cannery in Pago Pago. Many of the fishing vessels are based in Pago Pago or Fiji.

From 2009 onwards the level of catch and effort in the albacore fishery has increased significantly from the 3,072 tonnes caught in 2008.

In 2012 there were 80 fishing vessels which operated in the Cook Islands EEZ with total catch of 23,953 tonnes and landed value of $64.9 million dollars.

In 2012, the Ministry licensed 17 Chinese exploratory fishing vessels to develop the big-eye tuna and swordfish fishery. There was also an increase in activity by the US purse seine fleet compared to the previous 24 years of the treaty being in-force with a record number of 16 purse seine vessels fishing in the Cook Islands waters.

Table 2.9 Fishery Catches in the Cook Islands EEZ

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Designated longline fishery	825	2,151	3,467	3,409	3,115	3,446	3,072	7,047	7,070	8,467	10,478
Exploratory longline fishery											1,722
Purse seine fishery	3132	1,598	4	45	79	4	205	1,537	245	476	11,753
TOTAL CATCHES (tonnes)	**3,957**	**3,749**	**3,471**	**3,454**	**3,194**	**3,450**	**3,277**	**8,584**	**7,315**	**8,943**	**23,953**

The significance of 2012 catch is that the proven resources of the Cook Islands fishery have been expanded and diversified beyond the albacore through the addition of the big-eye long-line and skipjack tuna purse seine fisheries.

The Ministry of Marine Resources believes that the Cook Islands has now developed a significant "catch history" upon which it can begin to assert its rights to the regional fishery.

The Ministry intends to establish its EEZ zone based total allowable catches (TACs) and individual license quotas for the key species.

The Marine Resources (purse seine fishery) Regulations, 2013 has established a TAC of 30,000 tonnes per consecutive four quarters or 1,250 fishing days per annum.

In 2013/14 fisheries revenue will be generated by two main streams – (1) fees from fishing licenses and (2), catch revenue collected from the operators who wish to purchase unutilised quota from within the TAC.

In 2013/14 the US purse seine vessels will continue to operate under the US Fishery Treaty but the access for these vessels will be limited by the number of non-PNA fishing days currently capped at 300 days and beyond this the Cook Islands will "sell" to the fleet additional days.

There has been little activity from the domestic fleet operating in the southern fishery in 2013 as only several long-line vessels were recorded as fishing out of Rarotonga.

In 2013 the effort in the northern fishery has been incurred mainly by approximately 40 longliners targeting albacore and 12 purse seiners targeting skipjack tuna.

A decision was made to halt the bigeye exploratory program and designate the fishery which has not occurred hence there have not been dedicated big eye longliners operating to date. This may have an impact on revenue estimates, which may need to be updated at the time of the 2014/15 Budget.

In the second half of 2013 the Huanan Fishery Ltd (Cook Islands) vessels began monthly offloads of approximately 80 metric tonnes of frozen fish for trans-shipment by sea freight.

Fresh fish unloading occurred during the second half of 2013.

2.7 Pearls

Cook Islands pearls are sold on the domestic and international markets. The performance of the Cook Islands pearl industry is mainly assessed on the export trends over time because it is difficult to quantify the size of the domestic market. The domestic market is driven by and has a high correlation to the number of visitors into the Cook Islands. This market is catered to by a large number of local businesses and pearl vendors.

The value of pearl exports continued to decline from $1.6 million in 2009/10 to $0.3 million in 2011/12 (not including pearl shell). However, the production base in terms of seeded oysters during 2008-2012 has remained relatively stable at around 270,000 – 300,000 shells. In the December 2012 survey, seeded oysters were estimated at 279,000. The saleable pearl crop for 2013/14 is estimated to be 106,000 pearls.

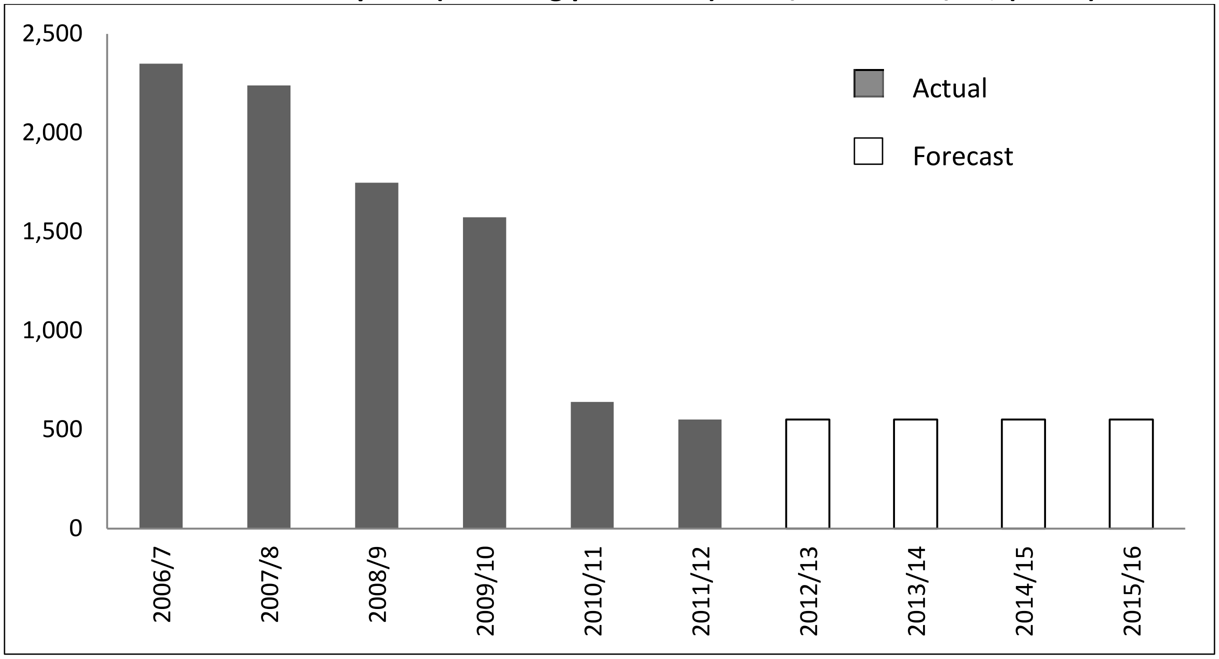
The current plan is to increase the production of Cook Islands pearls with the assistance of a revised NZ Aid Programme funded pearl production revitalisation programme which was approved in July 2013 and to be implemented by the Ministry of Marine Resources. Until such time that production increases are evidenced under this programme, the pearl production capacity over the next 2-3 years will continue to be stable and modest at around 270,000-300,000 seeded oysters, estimated to yield 106,000-115,000 saleable pearls.

Previously, the bulk of the pearls were exported with the domestic market only absorbing around 20 per cent of the annual crop. Since 2009, the declining export figures suggest that an increasing proportion of pearls are either being sold on the domestic market or are being stockpiled for future sale. Currently, the Cook Islands Pearl Authority's Pearl Exchange is holding stocks of pearls to be exported or sold domestically.

The decline in international market prices for black pearls since 2009 (current prices are the lowest on record) has had a major impact on the Cook Islands pearl industry. Global economic and financial conditions continue to weaken market demand and depress pearl prices in 2013 although there are emerging signs of modest improvements. It is expected that export levels in 2013/14 will be modest.

By international standards, the Cook Islands is a very small producer of pearls compared to Tahiti (for black pearls), Australia (for white South Sea pearls) or Asian countries (for gold South Sea pearls).

Chart 2.9 Pearl Exports (including pearl shell) 2006/07 to 2015/16, ($'000)



2.8 Agriculture

The Ministry of Agriculture retains and provides technical, biosecurity and pest emergency monitoring and advice to Agriculture divisions in the Outer Islands through their respective local Government administration.

Recently the Ministry of Agriculture, under the policy directives of the Cook Islands Government, adopted the strategic approach of Revitalizing the Agriculture sector in Rarotonga and the Outer Islands and to strengthen/up-skill growers' knowledge to become more efficient and resilient to outsmart the challenges of food security and climate change, addressing the potential impacts of climate change on Agriculture, and adopting green improved techniques to show how changing practices in the field can enhance growers income and sustainable economic livelihoods.

Recent changes in the global trading arena also affected our ability to trade fairly with our trading partners because of our inability to comply with our trading partners' quarantine import rules.

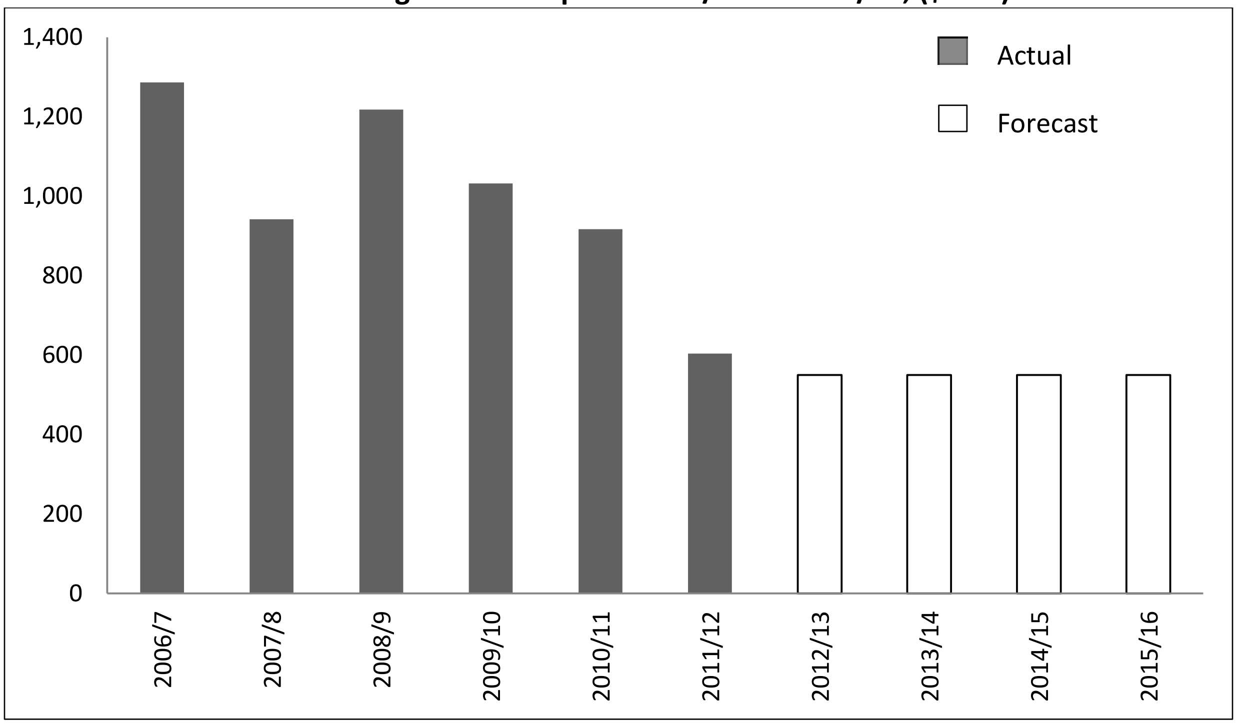
Agriculture remains a largely informal sector in the Cook Islands economy, and therefore, the total contribution to the economy remains difficult to quantify. The latest GDP estimate indicates that the agriculture sector accounted for less than 3 per cent of GDP in 2012.

The warm to mild climate and fertile soils of the Southern volcanic Islands of the Cook Islands has considerable scope for increased local agriculture production (root crops, fruit and vegetables). The supply and demand for produce is predominantly based in Rarotonga. However, limitations surrounding local enterprise, substandard facilities for international market access, labour shortages, water supply and high costs of transportation to get produce to markets (to Rarotonga and international markets), are major constraints in the agricultural sector.

Despite the growth in domestic demand from tourism, imports of food items have grown only a small amount, suggesting that domestic supply is growing to meet the increased demand.

Both international and domestic markets offer a number of opportunities for existing and potential crops, but structural constraints within the industry will continue to limit growth.

Chart 2.10 Agriculture Exports 2006/07 to 2015/16, ($'000)



Export of agricultural produce since 2009 continues to be minimal, and declining, in volume terms. Total estimated agricultural exports for the twelve months to the March quarter 2013 were $0.5 million, a 38.1 per cent fall for the same period in the previous year. Almost the entire agricultural export was made up of noni (91 per cent), with maire making up the remainder.

The decline in the export of agricultural produce is expected to continue for over the forward years, with domestic demand soaking up any surplus local supply in any produce that is not noni or maire – it is notable that the imports of food and live animals fell by $2.5 million in 2012 despite the demand for food products increasing due to visitor arrivals growing by 8,500 people over the same period. Pawpaw and vanilla production coming online may provide some opportunities to revise the export estimates, but benefits from public investment in these areas is yet to be realised.

2.9 Exports and Imports

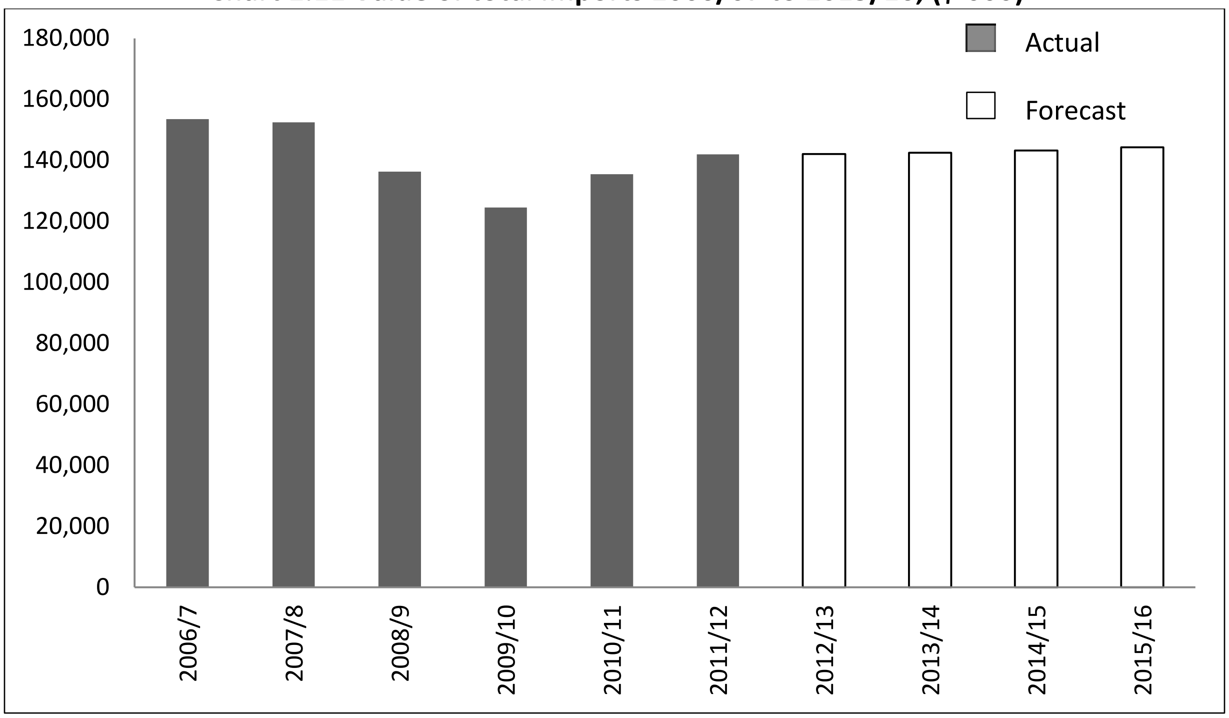
2.9.1 Imports

In 2011/12, the total value of imports to the Cook Islands was $135.3 million, an increase of 0.4 per cent from 2010/11. Data through to December 2012 shows that imports declined 7.4 per cent from December 2011, with 2012 showing 0.6 per cent lower value of imports as compared to 2011.

Imports for 2012 were predominantly made up of minerals and fuel (25.1 per cent); food and live animals (22.1 per cent); machines, transport and equipment (17.8 per cent); basic manufactures (such as construction material or textiles) (10.9 per cent); and miscellaneous manufactured goods (which includes finished or consumer goods) (9.3 per cent).

New Zealand continues to be the leading supplier of imports to the Cook Islands, accounting for approximately 69 per cent of total imports in 2012.

Chart 2.11 Value of total imports 2006/07 to 2015/16, ($'000)



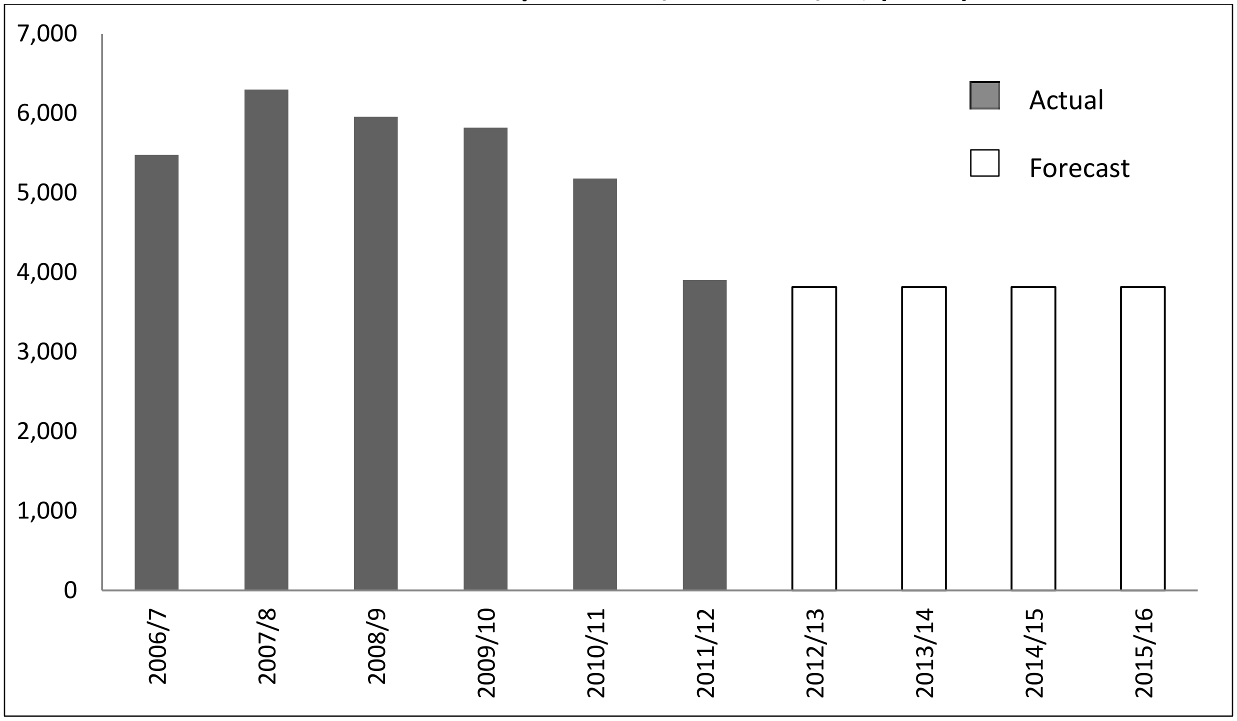
For calendar year 2012, it is estimated that import leakage from the Cook Islands was approximately 36 per cent – for every dollar spent in the Cook Islands economy, 36 cents went to foreign production. This is because of the Cook Islands heavy reliance on imported products to meet local demand (including that derived from the tourism industry).

2.9.2 Exports

Driven by a $2.9 million increase in the export of fresh or chilled fish, total exports increased by $2.6 million in 2012. Around 65 per cent of exports were sent to Japan in 2012.

For 2012, it is estimated that for every dollar earned in the economy, approximately 57 cents is derived from foreign sources (although this is almost exclusively driven by tourism, with a small contribution from export).

Chart 2.12 Total exports 2006/07 to 2015/16, ($'000)



Despite the increase in the exports of fish in the latter half of 2012, over the forecast horizon, exports are expected to remain relatively stable at the current low levels.

2.9.3 Balance of Trade

A negative merchandise balance of $138.1 million is estimated for 2012/13, a $7.7 million deterioration compared to 2011/12. Going forward, further deterioration in merchandise trade is expected due to growing import demand and stable exports.

Tourism dominates the services trade, with estimates for tourism spend reaching $221.2 million in 2012/13.

When estimated services trade is included, the resulting balance of trade is a surplus of $83.1 million. While there are no official capital account figures, estimates of a trade surplus (when including tourism arrivals) are supported by cash holdings at Banks in Rarotonga having to be transferred to New Zealand for prudential reasons – this prevents the build-up of cash reserves normally associated with trade surpluses. This trade surplus is expected to grow in line with increases in tourism spending rising faster than the associated increases in imports (as most tourism spending is paid to service provision).

Chart 2.13 Balance of Merchandise Trade 2006/07 to 2015/16, ($'000)

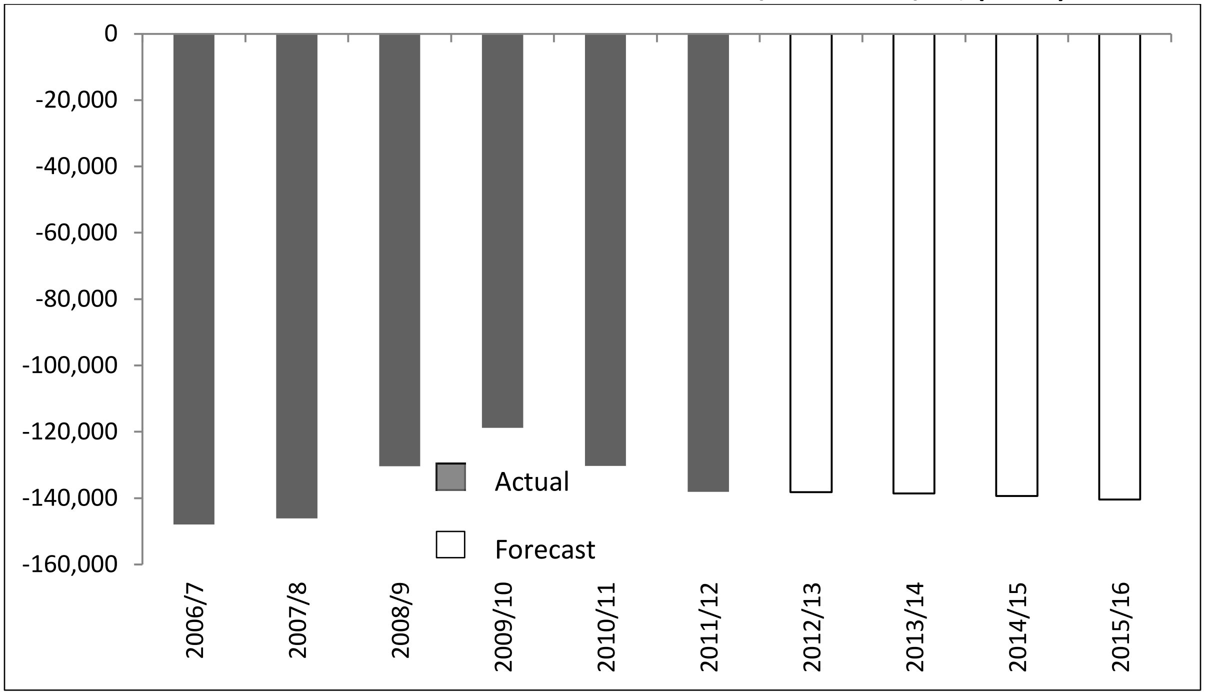
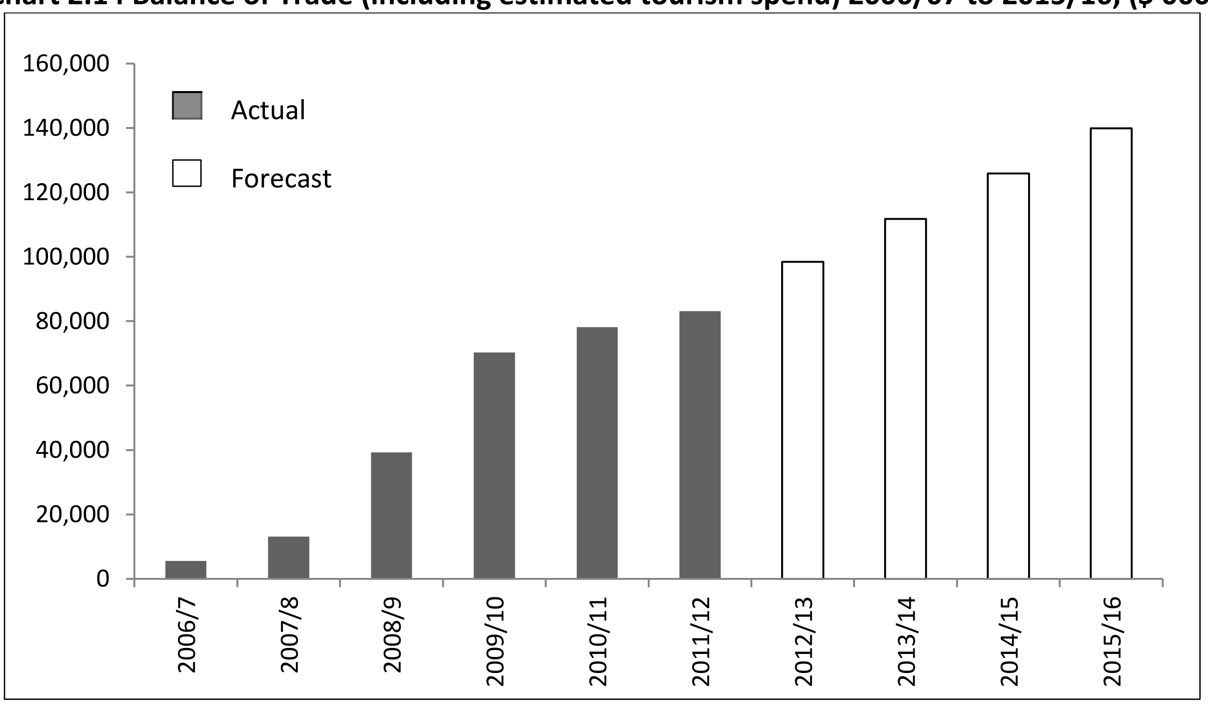


Chart 2.14 Balance of Trade (including estimated tourism spend) 2006/07 to 2015/16, ($'000)



2.10 Banking and Finance

The Reserve Bank of Australia reports that there has been a slight fall in financial stability due to continued issues surrounding profitability and non-performing loans in Europe, and signals from the US Federal Reserve that it may start scaling back its asset purchase program – this may have implications for the sourcing of credit for local banking operations.

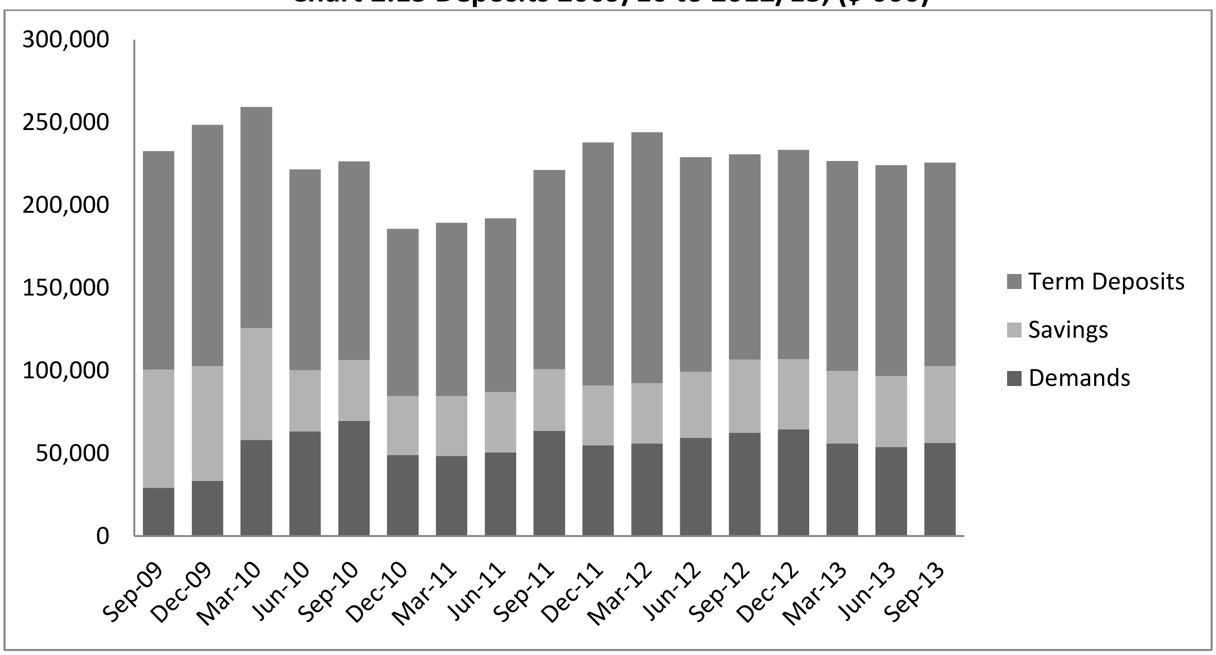
Domestically, non-performing loans and credit rationing remain an issue. The Banking Review being implemented in the latter half of 2013/14 should go some way to addressing issues within the sector, but progress is likely to be slow.

The addition of Capital Security Bank (CSB) to the surveyed banking institutions has dramatically altered the profile of financial data. Net foreign assets (NFA)[2] in the Cook Islands banking sector have decreased from $79.2 million in the September quarter 2012 to $37.0 million in the September quarter 2013 due to the large increase in foreign liabilities being less-than-matched by a large increase in foreign held assets.

2.10.1 Deposits

During 2013, total deposits have remained relatively stable. Total deposits decreased from $230.6 million in the September quarter of 2012 to $225.6 million in the September quarter 2013, a $5 million decline.

Chart 2.15 Deposits 2009/10 to 2012/13, ($'000)



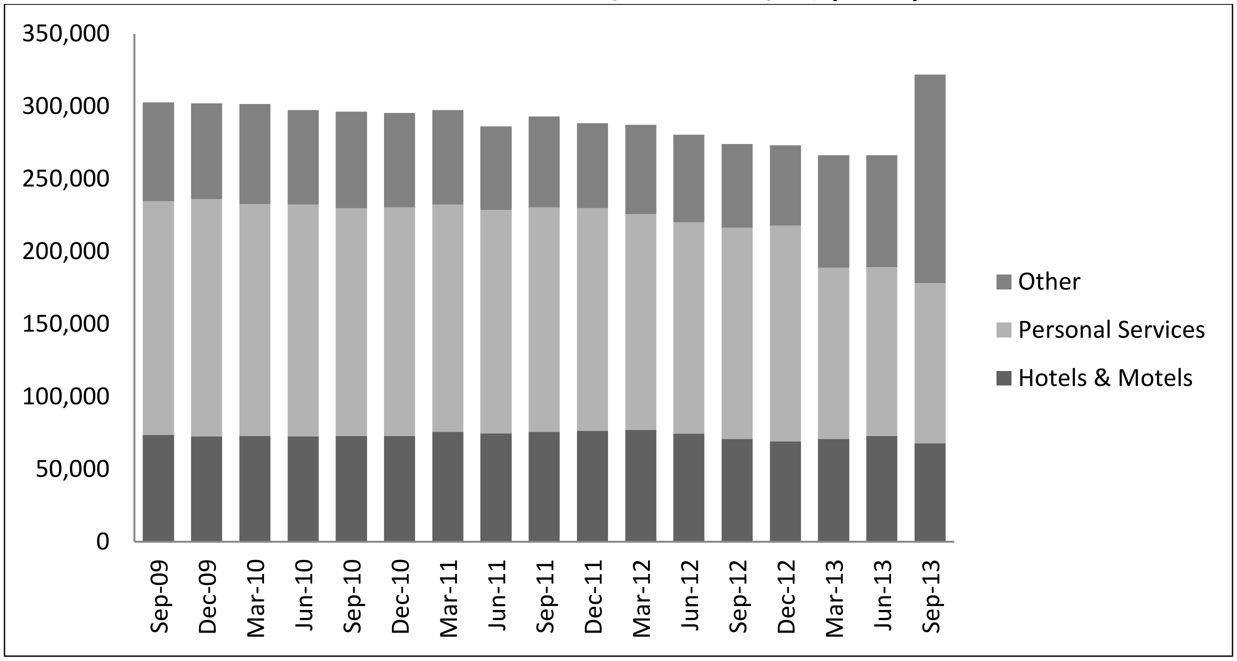
2.10.2 Loans

The overall total value of loans has been in a slow but steady decline since 2008. The addition of the CSB loan portfolio in the September quarter of 2013 increased the overall size of the loan portfolio to $321.9 million, the largest on record. Without the addition of CSB to the financial and business loan portfolio (shown in Chart 2.16 under 'other'), the remaining loan categories showed the typical decline, falling $29.3 million compared to the September quarter 2012.

The on-going portfolio of non-performing loans is expected to weigh on loan growth going forward, with demand for credit also remaining weak.

[2] Net foreign assets are the value of the assets that Banks own abroad, minus the value of domestic assets owned by foreigners

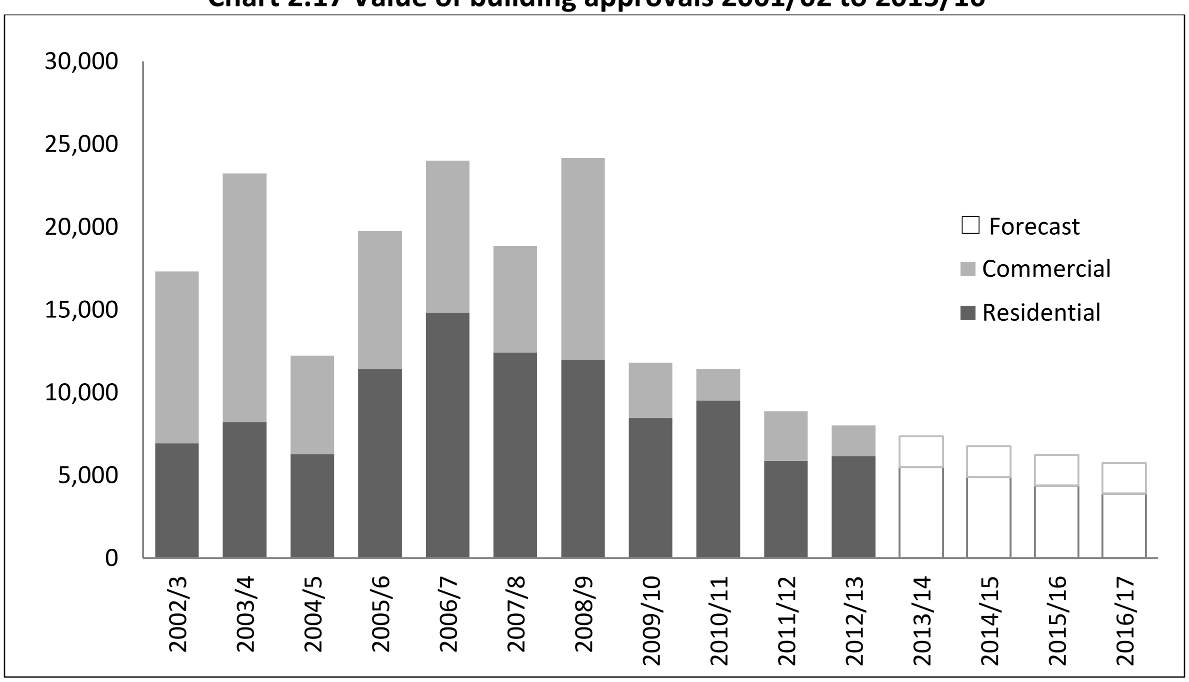
Chart 2.16 Loans 2009/10 to 2012/13, ($'000)



2.10.3 Housing and Construction

Building approvals have been in steady decline since 2006/07, with residential approvals falling 60 per cent between 2006/07 and 2011/12. Consistent with the positive contribution to 2012 GDP from construction activity, 2012/13 provided a much needed boost to building approval activity. Once the current pick up in commercial construction activity subsides, no further approvals have been granted or likely to be forthcoming. Residential approvals are expected to continue to fall over the forecast period.

Chart 2.17 Value of building approvals 2001/02 to 2015/16



2.11 Financial Services Industry

The financial services industry is estimated to collect fees to a net value of $1.4 million for services undertaken in 2013/14. Registration fees are generally denominated in USD, which means that some income is subject to exchange rate fluctuations.

The regulatory arm of the industry estimates 2 per cent annual growth in the number of new international companies, limited liability companies, and trusts registrations. The Foundations Act was enacted in 2012 and the trustee companies are now promoting the new entity. Captive Insurance legislation was passed in June 2013 creating a new revenue stream for government and trustee companies. The International Companies Act is in the process of being overhauled and expected to be passed in 2014.

New products and services as well as amended legislation for existing services are part of the effort to grow and diversify client markets. Focus continues on promotion of the jurisdiction in Asia particularly for trusts, foundations, and companies. Promotion of captive insurance in the next year will be targeted to the Australia and New Zealand corporate markets as well as to existing clients of the jurisdiction.

The industry continues to comply with international regulatory standards. 2014/15 will see a follow up evaluation of the Asia Pacific Group Mutual Evaluation Report on Anti-Money Laundering and Know Your Customer laws and practices. Phase 2 of the Global Forum Peer Review will also take place.

2.12 Sensitivity Analysis

As mentioned in section 5.2, there are several risks surrounding the forecasts presented here. Modelling these scenarios helps officials plan for possible contingencies should the outlook change and these risks become realised. MFEM has modelled four scenarios which are viewed as most likely to affect the forecasts and summarised them in Table:

Scenario 1: Weaker than expected tourism arrivals – if tourism arrivals are lower than expected, possibly due to extra capacity and fare competition from major markets to Bali and Hawaii.

Scenario 2: Aid capital projects experience slippage similar to that experienced in the last two years – aid project contribute a substantial amount to the local economy and key projects missing deadlines delays the economic benefit from wages, contractor fees, and the benefit of the completed infrastructure.

Scenario 3: The increase in VAT discourages marginal tourists from travelling to the Cook Islands when compared to other destinations – this has been modelled as the Cook Islands being a price elastic (price sensitive) destination, rather than the operating assumption of the Cook Islands being relatively price inelastic (less price sensitive).

Scenario 4: Retailers use the Tax Review as an excuse to increase prices by more than the impact of VAT and general inflation – inflation pressures in the economy have been well contained, but retailers may use the excuse of the VAT changes to increase their prices much higher than they should (price gouge the consumer). This is modelled by the CPI impacts of the Tax Review being double the maximum impact on prices of 2.1 per cent.

Table 2.10 Sensitivity Analysis of scenarios on parameters in 2014/15

Scenario	Nominal growth (per cent)	Real Growth (per cent)	Revenue ('000)	Change in revenue ('000)
Scenario 1: Weak tourist arrivals	1.7 per cent	-1.2 per cent	100,442	-1,115
Scenario 2: Slippage in capital projects	2.5 per cent	-0.4 per cent	100,780	-778
Scenario 3: Price response from tourists	1.8 per cent	-1.1 per cent	100,554	-1,003
Scenario 4: higher than expected inflation	2.3 per cent	-0.6 per cent	102,212	654

3 FISCAL UPDATE

3.1 Overview

The purpose of the Fiscal Update is to provide necessary revisions to the fiscal forecasts that underpinned the 2013/14 Budget published in June 2013. In updating the fiscal forecasts the following factors have been considered:

- year to date assessment of revenues and expenditure patterns against original Budget estimates 2013/14;
- updated economic forecasts which have impact on forecasted government revenues; and
- re-evaluation of debt stocks based on updated exchange rate movements and new loans.

3.1.1 Year to Date Assessment of revenues and expenditure patterns

Since the 2013/14 Budget published in June, economic conditions and the availability of new data have resulted in the forward revenue projections being shifted downwards. As modelled in the sensitivity analysis in the 2012/13 Budget, the slowing in tourism growth in earlier half of 2013 continued into the latter half of the year, resulting in lower than expected economic growth.

The net operating surplus for 2013/14 was estimated to be $0.046 million. After reviewing five months of actual receipts, tax revenue has been revised downwards by $0.7 million for the 2013/14 budget year. Tax revenue then increases by $2.9 million in 2014/15 due to the changes from the implementation of the Tax Review, principally the increase to VAT. Tax receipts would have fallen by more in 2013/14 if not for import levies and VAT receipts being higher than expected. As a result of these recent movements and the phasing of the Tax Review implementation, this results in a net operating deficits of $1.9 million for 2013/14, $1.2 million in 2014/15, and $0.8 million in 2015/16. The Budget returns back into surplus of $3.9 million in 2016/17.

There has been a slight reduction in other revenue expected to be collected for 2013/14, predominantly immigration fees have been reduced by $0.4 million as a result of the proposed new fee structure not being implemented and taking into account actual receipts received to date. This modest reduction has followed through to the outer years into 2016/17. In addition to this, a further $0.53 million will also be lost from the 2013/14 budget year due to the phasing arrangements for the Cook Islands Government 2013 Tax Review (the personal income tax cuts will occur in 1 January 2014, three months prior to the increase in VAT which is expected to commence on 1 April 2014).

Overall operating expenditure is expected to increase by $1.0 million, due largely to the increased payments to pensioners as a result of the endorsement of the recent Tax Review, whilst also taking into account $0.1 million being committed to topping up the Contingency Fund to cover emergencies and unexpected crown obligations that have recently occurred.

These revisions suggest that the 2014/15 Budget will be carried out under tight fiscal conditions and there is limited fiscal space for new initiatives in the upcoming budget process 2014/15. Therefore Crown expenditures will be monitored closely, and Government will need to consider cost saving policies to improve efficiencies.

3.1.2 Updated economic forecasts which have a direct impact on forecasted government revenues

Due to the downward revision of economic forecasts in 2013/14, the growth estimates for the forward years were also revised. In particular, growth in New Zealand and Australian arrivals were revised downward reflecting slower growth in 2013 than anticipated. Offsetting the downward revision to tourism, the implementation of the Tax Review recommendations will add significantly to GDP across the 2013/14 and 2014/15 budget years.

Nominal economic growth (which is what tax income is derived from) is estimated to be as follows:

- 3.7 per cent growth in 2012/13 (previously 5.7 per cent) due to tourism arrivals being less than forecast;
- 5.0 per cent growth in 2013/14 (previously 4.6 per cent) due large capital projects, the initial implementation of the Tax Review, and an improvement in tourism arrivals;
- 2.3 per cent growth in 2014/15 (previously 1.6 per cent) due to the remaining benefits from the Tax Review and a fall in aid projects compared to 2013/14; and
- 0.6 per cent growth in 2015/16 (previously 0.9 per cent) due to a large reduction in the aid expenditure profile.

3.1.3 Re-evaluation of debt stocks based on updated exchange rate movements

Total Crown debt is mainly denominated in Special Drawing Right (SDR) with 35 per cent, followed by the New Zealand Dollar (NZD) with 33 per cent, Renimbi (RMB) with 29 per cent and Euro (EUR) with 3 per cent.

As reported in this fiscal update, we have converted all loan denominated in USD ($23.3 million) held with the Asian Development Bank (ADB) into the local currency minimising our risk of exposure to movement in foreign exchange rate.

The NZD depreciate against all major exchange rates between the 2013-14 Budget and the time of this write up. It is worth noting that the EUR exchange rate depreciated the most by 4.1 percent which only affects 3 per cent of our loan portfolio followed by the SDR with 2.1 per cent explaining the unrealised foreign exchange loss reported.

The Government continues to adopt a prudent fiscal stance due to the vulnerability which would arise in the event that one or both of our major trading partners (New Zealand and Australia) are impacted by a continued global instability.

To control the impacts of fiscal policy on fiscal and macroeconomic stability, the Government of the day must operate within the fiscal responsibility principles outlined in the *Ministry of Finance and Economic Management Act 1995/96* as follows:

- ensuring that unless Crown debt is at prudent levels, operating expenses will be less than operating revenues (Government will run an operating surplus);
- achieving and maintaining levels of Crown net worth that provide a buffer against factors which may impact adversely on net worth in the future;
- managing prudently the fiscal risks facing the Crown; and

- pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

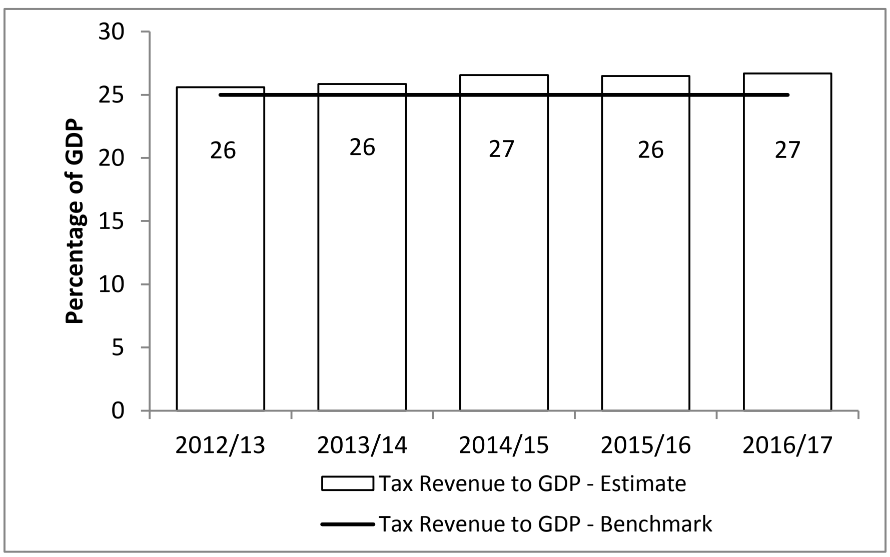
The Ministry of Finance and Economic Management quantifies these principles through the Fiscal Responsibility Ratios (FRR) as reported in the 2013/14 Budget. The performance of each of the FRR's are discussed below, discussing the benchmarks of these ratios and performance in 2013/14 and expectations for 2014/15 based on revised forecasts.

3.1.4 Tax Revenue to GDP

This ratio sets the revenue boundary and ensures government limits the diversion of resources away from the private sector. The benchmark government agrees to work within is maintaining collections to within 25 per cent of GDP. The expected performance against this benchmark is illustrated in Chart 3.1.1 below. It is important to note that following an IMF mission to the Cook Islands, Departure tax has been reclassified as a tax rather than an administration fee.

This indicates that based on current estimates, Government has slightly exceeded the benchmark as a result of the increase in VAT being effective as of 1 April 2014.

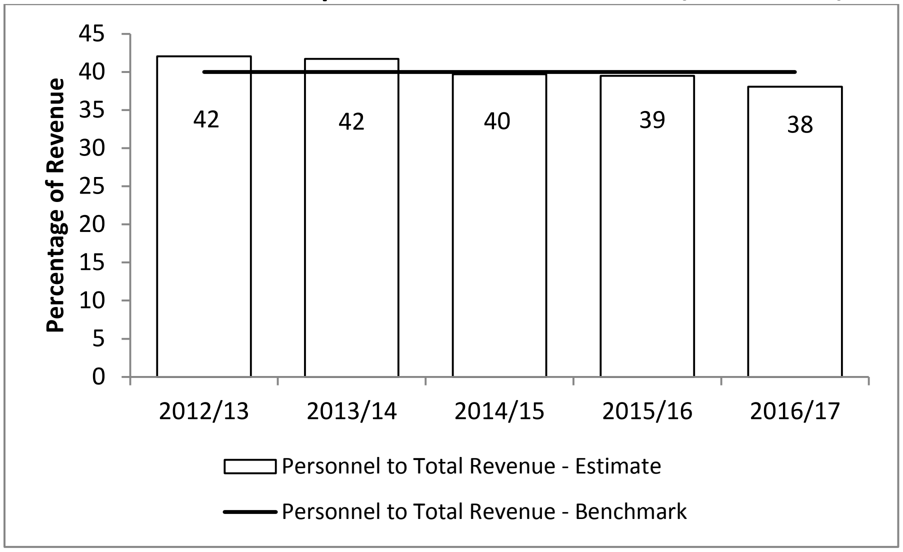
Chart 3.1 Tax Revenue to GDP 2012/13 to 2014/15 Personnel to GDP



3.1.5 Personnel Expenditure to Revenue

This ratio is aimed at controlling the expansion in the size of the public service as the largest expenditure item of Government. The benchmark government agrees to work within is maintaining expenditure on personnel within 40 per cent of total revenues. As illustrated in Chart 3.2, the Government is expecting to bring the overall ratio down to 40 per cent by 2014/15. Over the medium term it is expected to come within the benchmark on the basis that the economy and revenue continues to expand as forecasted.

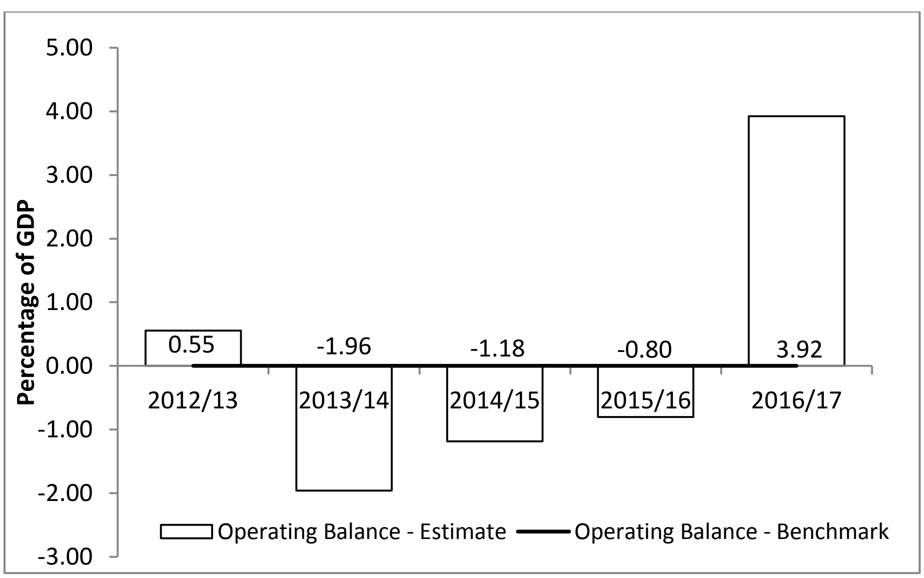
Chart 3.2 Personnel Expenditure to Revenue 2012/13 to 2014/15



3.1.6 Underlying Net Operating Balance

Maintaining a positive operating balance indicates that Government is able to afford the operational costs of performing the functions of government from its own revenue streams. Government has set a benchmark of running an operating surplus in each Budget. As illustrated below, it is anticipated that Government has an underlying operating deficit of $1.9 million in 2013/14 due to the phasing of the Tax Review. Going forward, changes in expenditure and revenue estimates are predicted to result in a $1.2 million operating deficit in 2014/15 and a $0.8 million deficit in 2015/16. Government will need to implement policy measures to improve cost recovery for service rendered by line ministries whilst also taking into account saving measures to improve efficiencies in Government.

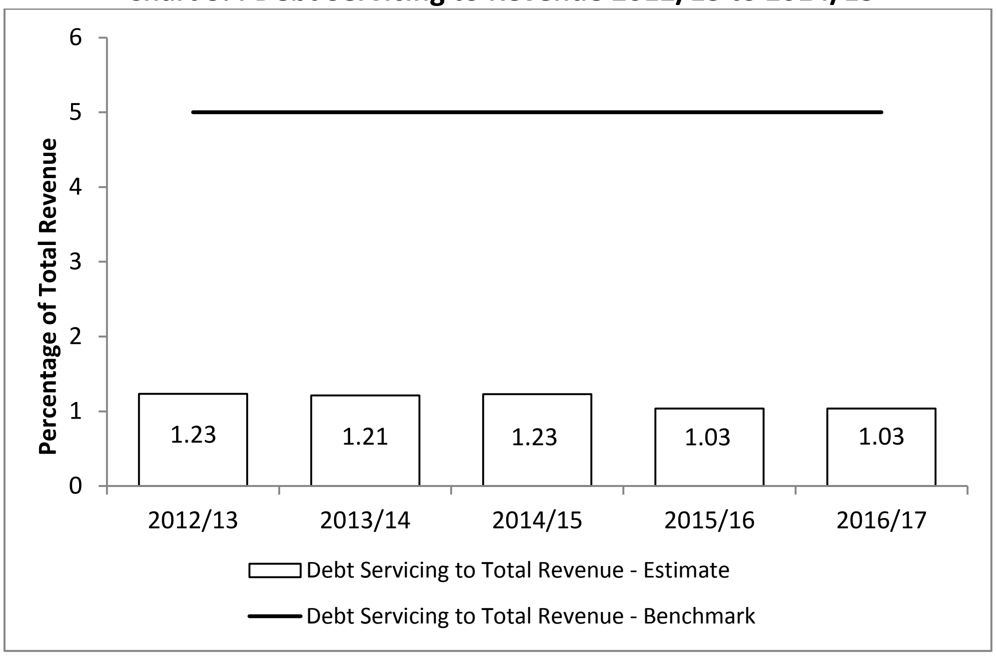
Chart 3.3 Underlying Operating Balance 2012/13 to 2014/15



3.1.7 Net Debt Servicing to Revenue

Debt servicing to total revenue measures the ability of Government to service its debt obligations from revenue collected. Debt servicing includes both interest, principle, and is now net of drawdowns of loan reserves to more accurately reflect the ability of Government to service its debt obligations. The benchmark set is to maintain within five per cent of revenue. With this amendment to the ratio the level of debt servicing against benchmarks within the short to medium term is maintained within the benchmark as shown in Chart 3.4.

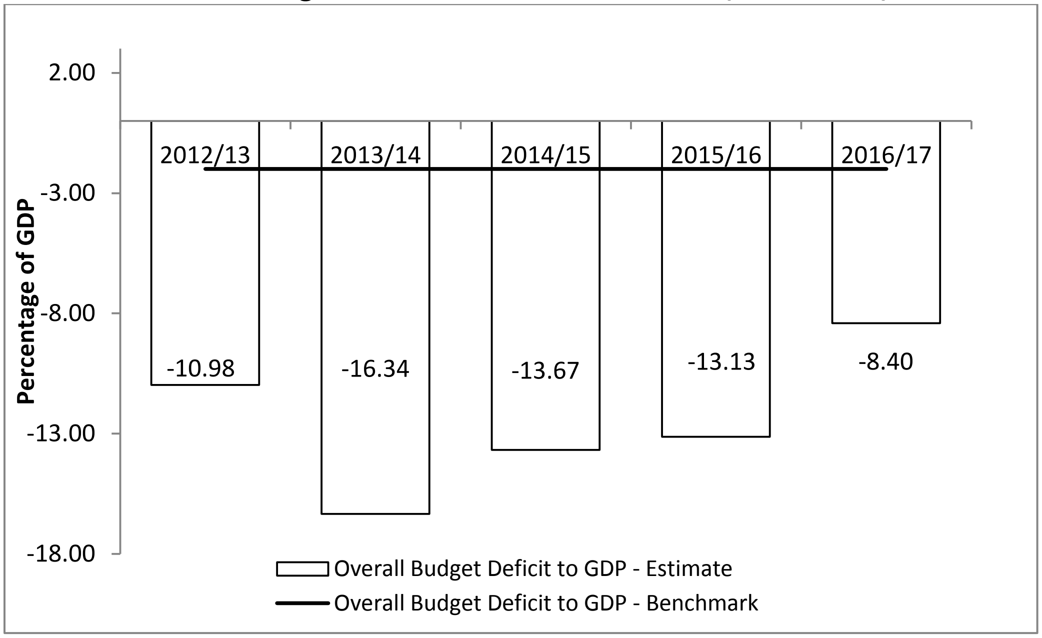
Chart 3.4 Debt Servicing to Revenue 2012/13 to 2014/15



3.1.8 Budget Overall Balance to GDP

Budget Overall Deficit is the operating balance less non-operating expenditure (purchase of assets and repayment of liabilities). Where the budget overall balance is in deficit, it must be serviced through lending or payment through reserve funds. The benchmark is set to be maintained within -/+2 per cent to ensure that government does not accumulate debt too quickly, and taken together with the debt servicing to total revenue and net debt to GDP ratios ensures that debt is managed and taken on within sustainable levels. Chart 3.5 illustrates that Government expects to maintain within the benchmark limits over the short to medium term.

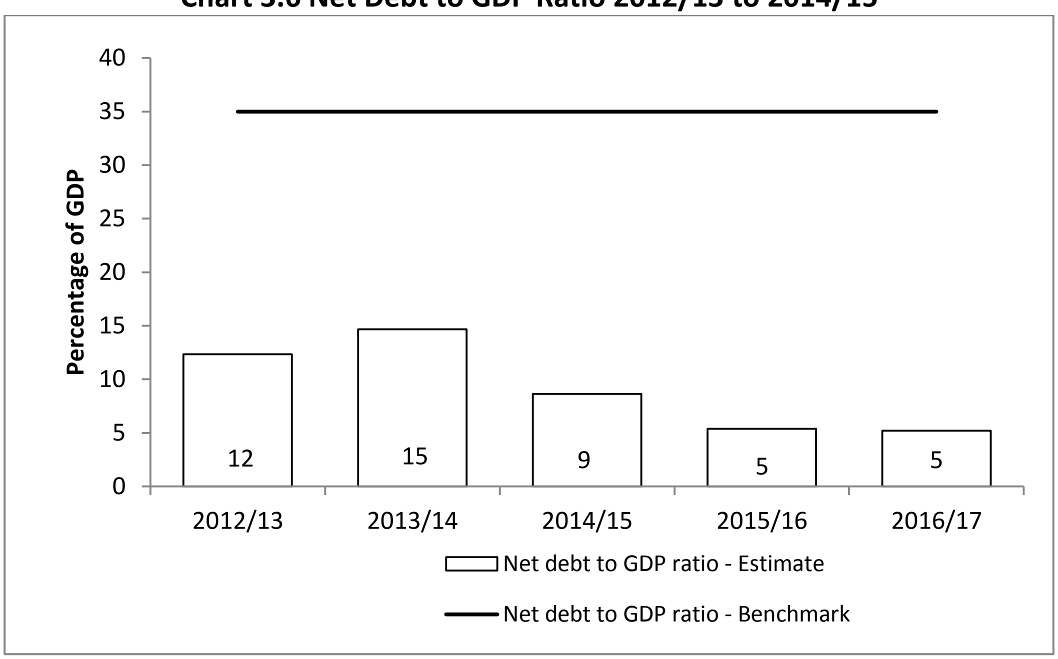
Chart 3.5 Budget Overall Balance to GDP 2012/13 to 2014/15



3.1.9 Net Debt to GDP

Net debt to GDP measures the level of debt relative to national income and is intended to control the overall level of debt taken on by Government including SOE's. The benchmark agreed to by Government is to maintain net debt within 35 per cent of GDP. This would represent total borrowings of $132 million estimated in 2011/12. Chart 3.6 illustrates that Government is well within the benchmark over the short and medium term. The significant reduction since the time of the 2011/12 Budget is due to a revaluation of debt based on favourable exchange movements.

Chart 3.6 Net Debt to GDP Ratio 2012/13 to 2014/15



3.1.10 Summary of Medium Term Fiscal Policy

The Government will undertake the following fiscal strategies to ensure the FRR are achieved whilst providing limited space for further policy initiatives.

Following the revisions for 2014/15 Budget, the fiscal setting should be carried out under tight fiscal conditions. Therefore Government will need to consider cost saving policies and initiatives. New budget initiatives will be supplemented by identifying initiatives that can be funded through efficiencies gained in other areas of government operations.

Actively engage with donor partners to align development assistance to this policy statement and our longer term priorities outlined in our National Sustainable Development Plan 2011-2015; and

Continue to put a portion of total tax receipts into the reserve trust fund building a buffer to protect the net worth of the Crown.

Table 3.2 Fiscal Indicators Update

	FY12/13 Estimate	FY13/14 Estimate	FY14/15 Proj	FY15/16 Proj	FY16/17 Proj
Statement of Financial Performance					
Taxation Underlying Revenue ($m)	98.5	104.5	109.8	110.2	114.9
Social Contributions ($m)	0.1	0.1	0.1	0.1	0.1
Other Underlying Revenue ($m)	12.5	13.3	13.7	13.8	13.8
Total Operating Underlying Revenue ($m)	**111.06**	**117.86**	**123.62**	**124.03**	**128.76**
Total Underlying Underlying Revenue Percentage of GDP ($m)	28.9	29.2	29.9	29.8	29.9
Tax Underlying Revenue Percentage of GDP ($m)	25.6	25.9	26.6	26.5	26.7
Personnel ($m)	**46.7**	**49.2**	**49.1**	**49.0**	**49.0**
Percentage of Total Underlying Revenue	42.0	41.7	39.7	39.5	38.0
Total Operating Underlying Expenditure ($m)	**113.7**	**119.8**	**124.8**	**124.8**	**124.8**
Percentage of GDP	29.6	29.6	30.2	30.0	29.0
Percentage of Operating Underlying Revenue	102.4	101.7	101.0	100.6	97.0
Re-appropriation of Previous Years Funds for Capital ($m)	3.1	0	0	0	0
Underlying Operating Balance ($m)	0.554	(1.963)	(1.185)	(0.805)	3.924
Percentage of GDP	0.1	(0.5)	(0.3)	(0.2)	0.9
Non-Operating Balance ($m)	(11.5)	(14.4)	(12.5)	(12.3)	(12.3)
Underlying Overall Surplus/(Deficit) ($m)	**(11.0)**	**(16.3)**	**(13.7)**	**(13.1)**	**(8.4)**
Percentage of GDP	2.9	4.0	3.3	3.2	2.0
Statement of Financial Position ($m)					
Assets ($m)	486.06	490.34	504.50	502.87	504.56
Liabilities ($m)	114.81	121.24	122.49	117.72	112.66
Crown Balance ($m)	371.26	369.10	382.01	385.15	391.90
Percentage of GDP	96.49	91.32	92.39	92.60	91.04
Statement of Borrowings ($m)					
Gross Debt end of FY ($m)	95.88	102.32	103.57	98.80	93.74
Percentage of GDP	24.92	25.32	25.05	23.75	21.78
Net Crown Debt, end of FY ($m)	52.08	61.63	64.28	61.09	59.02
Percentage of GDP	13.54	15.25	15.55	14.69	13.71
Loan Repayment Reserves Held ($m)	16.31	16.30	15.06	13.79	11.32
Development Partner Support ($m)					
Grants ($m)	47.50	59.36	35.78	22.35	22.35
Percentage of GDP	12.34	14.69	8.65	5.37	5.19
Net Debt Servicing1 ($m)	1.37	1.43	1.52	1.28	1.28
Percentage of Total Underlying Revenue	1.23	1.21	1.23	1.03	1.03
Memo item: Nominal GDP ($m)	384.76	404.18	413.47	415.95	430.49

1. Note change in formula since the Budget Estimates 2012/13. Net Debt servicing is now net of drawdown of loan reserves used to service SOE debt repayments.

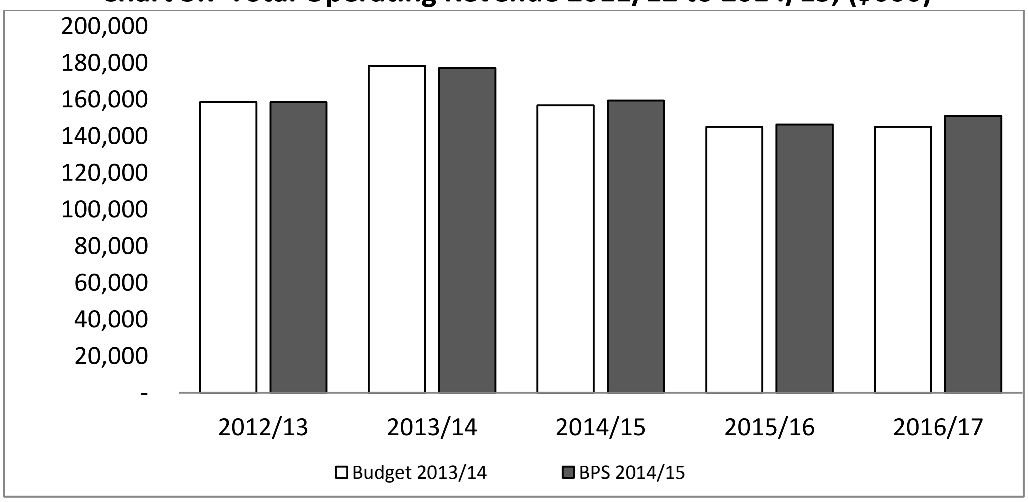
3.2 Government Financial Statistics (GFS) Operating Statement

The Operating Statement reflects the financial performance of Government and discusses general trends and revisions of forecasts for operating revenues, operating expenditures and the resultant operating balance.

3.2.1 GFS Operating Revenue

Operating revenues are made up of taxation receipts (59 per cent), Grants/ODA (34 per cent) and other revenues, which include ministry trading revenues, interest and dividend receipts (7 per cent). These revenue streams are used to finance the on-going operational expenditure of government, with surpluses used for investing activities such as infrastructure development projects (where apparent).

Chart 3.7 Total Operating Revenue 2011/12 to 2014/15, ($000)



At the time of the 2013/14 Budget published in June, GFS Operating revenues in 2013/14 were estimated to total $178.3 million in June 2013, of which $105.2 million was expected to be collected in taxes over the financial year.

Since the 2013/14 Budget, movements in taxation revenues have resulted in a downward revision of operating revenues by $1.0 million to $177.2 million, due to both parameter and policy changes.

Total tax receipts are for 2013/14 are expected to be $0.7 million lower due to a downward revision in tourist arrival numbers, income tax receipts, and GDP. In addition to this, the implementation of the Tax Review will result in an estimated $5.4 million less in income tax receipts from 1 January 2014, and the elimination of certain trade tariffs from 1 April 2014 will result in an estimated $0.1 million reduction in tariff income in 2013/14. Offsetting this somewhat is the increase to the VAT rate which will add $2.4 million to 2013/14 tax revenue. Overall, there is an estimated $0.7 million reduction in tax revenue for 2013/14.

For 2014/15, tax revenue is anticipated to be $2.9 million higher than previously forecast, due almost exclusively to the full implementation of the Tax Review. The increase in revenue from the Tax Review is diminished to $1.6 million in 2015/16 due to wholesalers avoiding the final increase in the tobacco levies by bringing forward tobacco purchases into the 2014/15 tax year. This effect is not anticipated to occur in

2016/17, resulting in both import levies and the Tax Review changes adding $6.3 million to total tax revenue in that year.

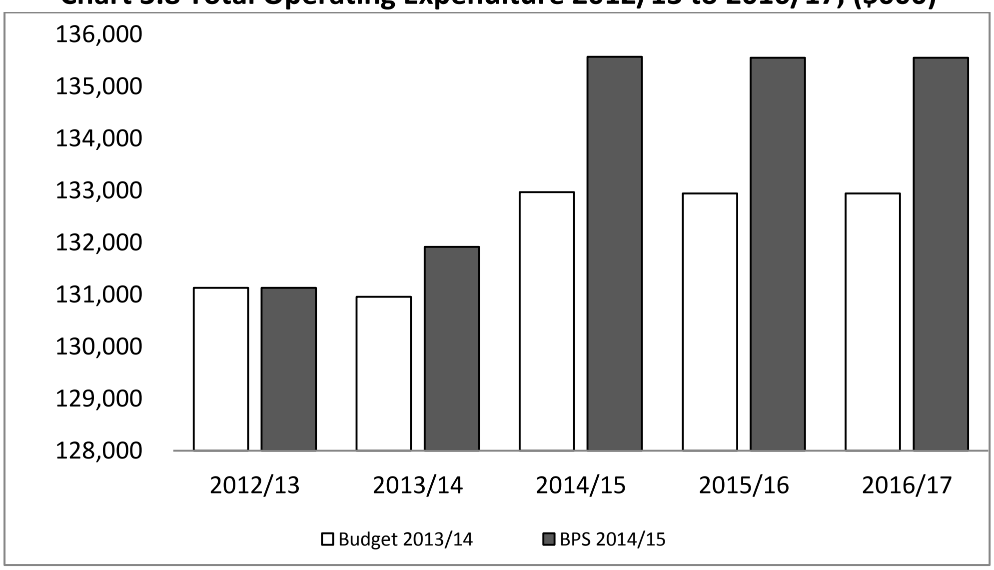
As a result of the Tax Review, the tax free threshold has increased from $10,000 a year to $11,000 a year, the tax thereafter will reduce from 25 per cent to 18.5 per cent, and a new bracket introduced between $30,000 and $80,000 of 27.5 per cent as opposed to 30 per cent, and the highest marginal rate will apply at $80,000.

There is little to no movement on estimates for the revenue other than Immigration fees which have been reduced by of $0.4 million, reflected by delayed implementation of new the fee structure. The $0.6 million annual forecast for immigration fees takes into account increase in capital infrastructure projects and influx of foreign workers, namely the Te Mato Vai project. Estimates are estimated to continue to decrease in the outer years, but dependent on implementation of a new immigration fee structure.

3.2.2 GFS Operating Expenditure

Operating expenditure is made up of Compensation of Employees (37 per cent), Use of Goods and services (28 per cent), Subsidies (12 per cent), Social Benefits (12 per cent), and Depreciation (7 per cent) and other expenses, which include interest expense (3 per cent).

Chart 3.8 Total Operating Expenditure 2012/13 to 2016/17, ($000)



Operating expenditures at the time of the 2013/14 Budget were estimated at $130.9 million in June 2013, these have been revised upwards slightly to reflect an increase of $1.0 million in the Welfare POBOC to reflect payment increases to pensioners and a moderate increase to the Crown's Contingency Fund.

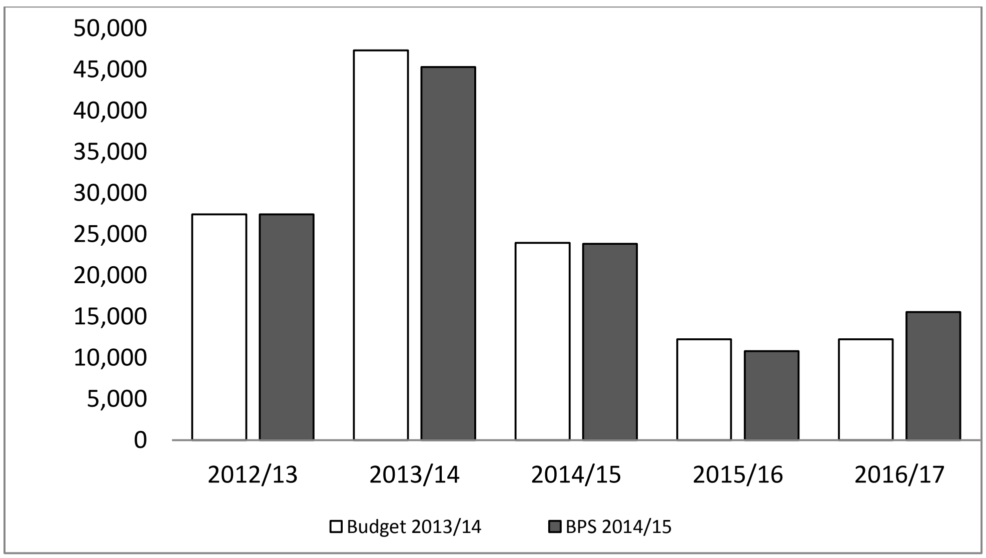
On 1 March 2014, the Government will increase pensions by 25 per cent, those who are aged over 70 will now collect $625 per annum, and those who are between 60 and 70 will now collect $500 per annum. For those over 70, this is a $125 a month increase; for those above 60, this is a $100 increase – taking this closer to Government's promise to double the 70 plus pension.

3.2.3 GFS Net Operating Balance

The GFS operating balance is the balance of operating revenues minus operating expenditure as prescribed by the MFEM Act. Given the analysis provided in sections 3.2.1 and 3.2.2, the net underlying operating balance in 2013/14 at the time of the budget was estimated at $0.046 million, considering the revised estimates mentioned above, the net operating balance has been revised to a deficit of $2 million, due in large part to the phasing arrangements of the Tax Review.

Going forward, changes in expenditure and revenue estimates are predicted to result in a $1.2 million operating deficit in 2014/15, and a $0.8 million deficit in 2015/16 . It is anticipated that a recovery in import levies and GDP growth results in an operating surplus of $3.9 million in 2016/17. GFS Net Operation surplus is demonstrated below in Chart 3.9.

Chart 3.9 GFS Net Operating Balance 2012/13 to 2016/17, ($000) Update



Changes to the GFS operating balance and the underlying operating balance since the time of the 2013/14 Budget are shown below in Table 3.1, Table 3.2 and Table 3.3 respectively.

Table 3.1 Changes to GFS Operating Balance since 2013/14 Budget Estimates ($000)

	2013/14	2014/15	2015/16	2016/17
Net Operating Balance - 2013/14 Budget	47,313	23,946	12,240	12,240
Change to Operating Revenues	-1,047	2,486	1,192	5,921
Change to Operating Expenditures	962	2,603	2,603	2,603
GSF Operating Balance as at 2014/15 BPS	45,304	23,829	10,829	15,558

Note: The table above summarises total movements in operating revenues and operating expenditure since the time of the Budget 2013/14 in the GFS format published in June 2013.

Table 3.2 Reconciliation of GFS Operating Balance and the Underlying Net Operation Balance 2012/13 to 2016/17 ($000)

Statement of Government Operations	2012/13 Estimates $'000	2013/14 Budget $'000 (June)	2013/14 Budget $'000 (BPS)	2014/15 Projected $'000	2015/16 Projected $'000	2016/17 Projected $'00	Variance
NET GFS Operating Balance	27,425	47,313	45,304	23,829	10,829	15,558	-2,009
GFS Revenue	158,558	178,268	177,221	159,400	146,379	151,108	-1,047
Remove ODA Revenue	47,498	59,364	59,364	35,784	22,350	22,350	0
CISNOC Reimbursement Olympic	93	0	0	0	0	0	0
Underlying Revenue	111,153	118,904	117,857	123,616	124,029	128,758	-1,047
GFS Expenditure	131,133	130,956	131,918	135,572	135,550	135,550	962
Remove ODA Expenditure	17,316	12,098	12,098	10,771	10,716	10,716	0
CISNOC Reimbursement Olympic	-93	0	0	0	0	0	0
Underlying Expenditure	113,724	118,858	119,820	124,801	124,834	124,834	962
Underlying Budget Balance	-2,571	46	-1,963	-1,185	-805	3,924	-2,009
Re-appropriated Capital Expenditure	3,125	0	0	0	0	0	0
UNDERLYING NET OPERATING BALANCE	**554**	**46**	**-1,963**	**-1,185**	**-805**	**3,924**	**-2,009**

The above table provides an updated reconciliation on the net operating balance between the GFS framework standard and the previous budget framework format, recognising the two different budget measures.

Table 3.3 Reporting of Underlying Net Operation Balance 2013/14 to 2016/17

Statement of Government Operations	2013/14 Budget $'000	2014/15 Projected $'000	2015/16 Projected $'000	2016/17 Projected $'00
Net Underlying Operating balance 2013/14	**46**	**-1,068**	**606**	**606**
Revenue				
Total Parameter Changes	**-180**	**216**	**-1,075**	**3,654**
VAT Adjustments	475	771	659	2,047
Income Adjustments	-2,792	-1,612	-1,190	-221
Import Levies Adjustments	2,097	1,873	403	1,986
Company Tax Adjustments	1,074	712	680	1,079
Departure Tax Adjustments	-1,333	-1,529	-1,626	-1,236
Withholding Adjustments	300	0	0	0
Other ROBOCs	0	0	0	0
Total Changes due to Decisions	**-867**	**2,270**	**2,267**	**2,267**
Delayed increase in immigration fees	-336	-381	-385	-385
Cancellation of pork levies	-57	-229	-229	-229
Cancellation of fruit and vegetable levies	-19	-74	-74	-74
Cancellation of shipped eggs levies	-	-	-	-
Cancellation of ice cream levies	-26	-106	-106	-106
Increase in the VAT	1,959	7,835	7,835	7,835
Decrease in personal income rates and raising the tax-free threshold	-2,888	-5,775	-5,775	-5,775
Remove international airline exemption	250	500	500	500
Include interest earnings as part of general income	250	500	500	500
Total Revenue Changes	**-1,047**	**2,486**	**1,192**	**5,921**
Expenditure				
Parameter Changes	**0**	**0**	**0**	**0**
Decisions	**962**	**2,603**	**2,603**	**2,603**
Tax Review Welfare Payments				
Increase 60-69 pension by 25 per cent	404	1,212	1,212	1,212
Increase 70+ by 25 per cent	345	1,035	1,035	1,035
Increase child benefit by 10 per cent	86	258	258	258
Increase destitute by 10 per cent	13	40	40	40
Increase Caregivers by 10 per cent	17	50	50	50
Increase Power Subsidy by 10 per cent	3	9	9	9
Overspending Operating Contingency Fund	94			
Total Expenditure Changes	**962**	**2,603**	**2,603**	**2,603**
FINAL UNDERLYING NET OPERATING BUDGET BALANCE	**-1,963**	**-1,185**	**-805**	**3,924**

The 2013/14 underlying operating balance takes into account the removal of ODA revenue and expenditure.

The underlying operating balance was initially estimated at $0.046 million at the time of the Budget, after the revision of estimates this has arrived to a budget deficit of $1.9 million. Going forward, changes in expenditure and revenue estimates are predicted to result in a $1.2 million operating deficit in 2014/15, and a $0.8 million deficit in 2015/16. It is anticipated that a recovery in import levies and GDP growth results in an operating surplus of $3.9 million in 2016/17. This is mainly due to the parameter changes in the total revenue profile, as the increased expenditure and lower income tax receipts from the Tax Review changes have been fully offset by the increase in VAT receipts. It should be noted that the 2014/15 net underlying operating balance is still in deficit and Government will need to implement policy measures to improve cost recovery for service rendered by line ministries whilst also taking into account saving measures to improve efficiencies in Government.

3.3 Crown Debt and Net Worth

3.3.1 Gross Debt owed by the Crown

Total gross debt owed by the Crown by end of November 2013 was $84.9 million, a variance of $15.2 million from what was initially estimated during the 2013-14 budget. The difference was due to timing in drawdown of borrowing which are now scheduled to happen in the second half of this financial year.

Table 3.4 shows further reconciliation and Crown is now estimated to owe $102.3 million by the end of June 2014 due to an unfavorable movement in exchange rate of $2.2 million;

Table 3.4 Reconciliation on 2013/14 Loan Movement

Movement Reconciliation	**$ million**	**$ million**
Gross debt actual as at 30/11/2013		84.9
Reconciliation items		
Water Ringmain Project - Exim Bank	15.9	
Unrealised exchange (gain)/loss	-0.7	
Total reconciliation items		15.2
Gross debt estimated during 2013-14 budget		100.1
Unrealised exchange (gain)/loss		2.2
Estimanted gross debt for 30/06/2014		**102.3**

The exchange rate used for this write up reflects the monthly average for the period of November 2013. Past changes in major exchange rates against the New Zealand dollar (NZD) are reflected in Chart 3.10.

Chart 3.10 Changes in Major Exchange Rates

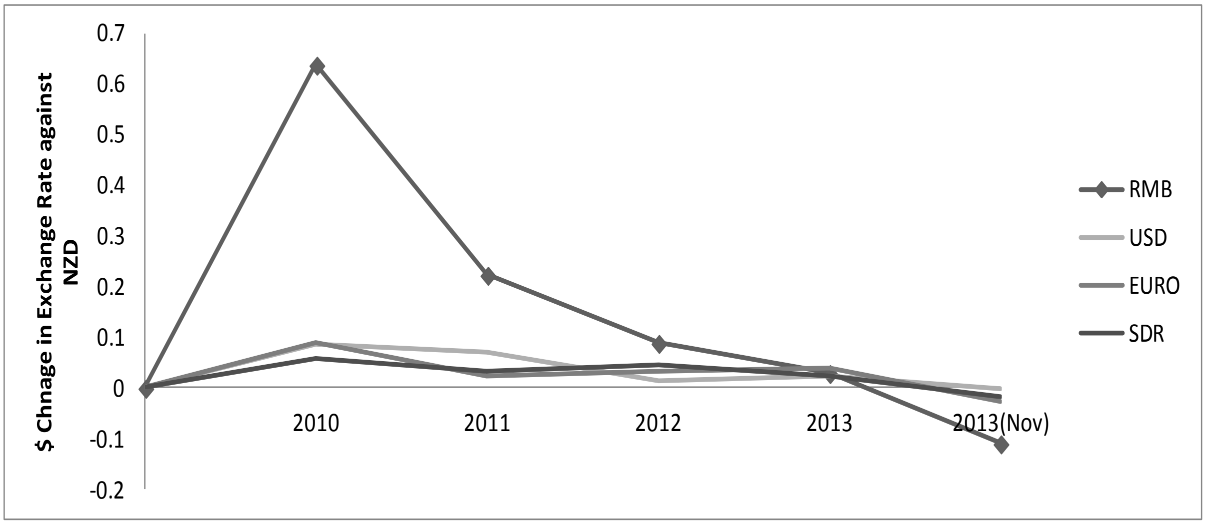


Chart 3.10 illustrates the steady overall appreciation of the New Zealand dollar from 2010 to November 2013.

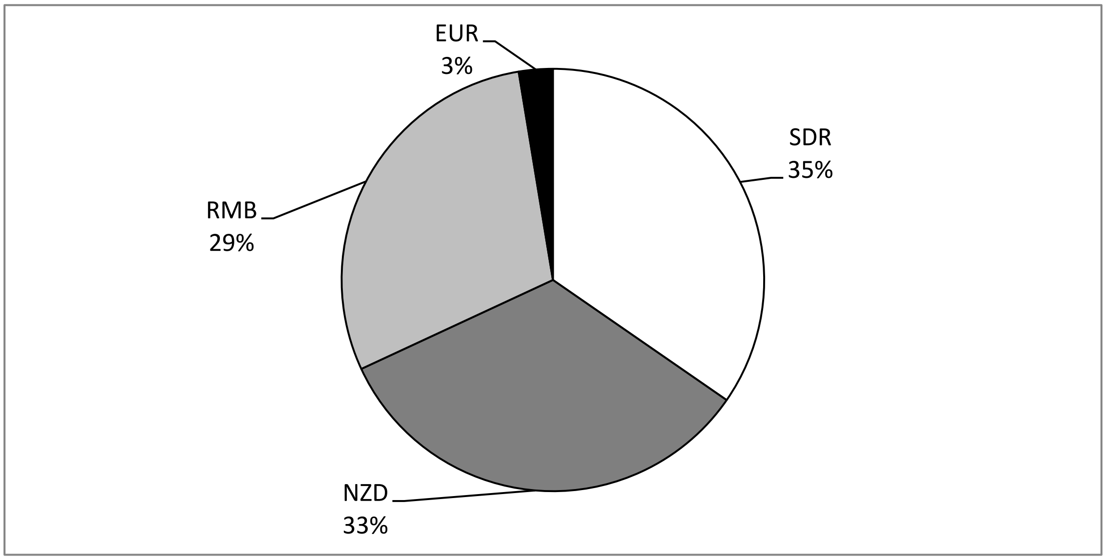
The assumption on the future value of the New Zealand dollar assumes that the trend movement as outlined in the above chart will remain constant into the outer years.

Table 3.5 Average Exchange Rates Used

Foreign Exchange Currency	November 2013 Average	March 2013 Average	changes
EUR	0.6125	0.6386	-4.09 per cent
USD	0.8265	0.8279	-0.17 per cent
RMB	5.0363	5.1460	-2.13 per cent
SDR	0.5341	0.5506	-3.00 per cent

Table 3.5 shows the movement between exchange rates used during the 2013-14 estimates and this half year fiscal update. New Zealand dollar (NZD) depreciate against all major trading currencies in which Government debt is denominated.

Chart 3.11 Composition of Crown Debt as at 30 November 2013 by Currency



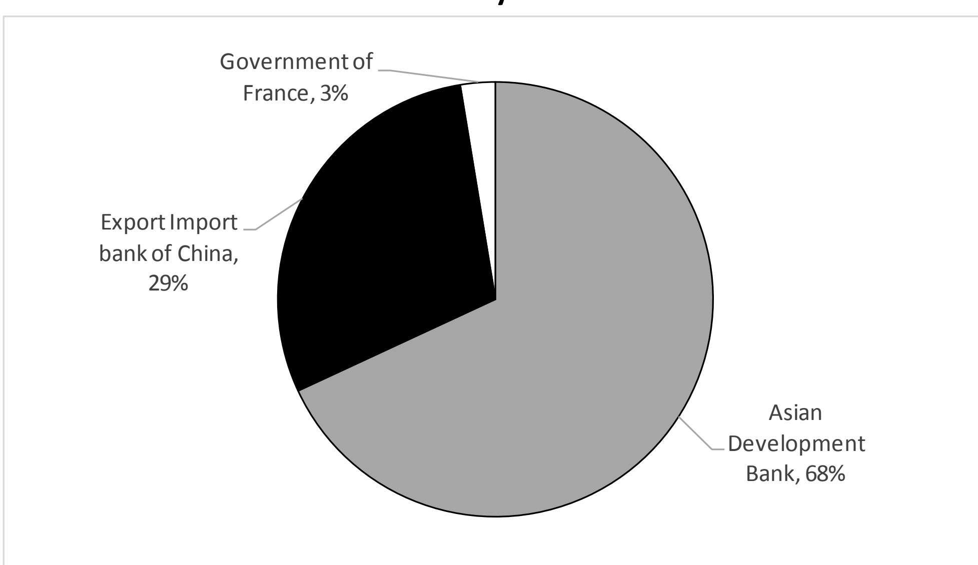
Total Crown debt as reported is mainly denominated in Special Drawing Right (SDR) with 35 per cent, followed closely by NZD with 33 per cent, Renminbi (RMB) 29 per cent and Euro (EUR) three per cent respectively.

As reported during the 2013/14 budget write up, the share of NZD have now increased from seven per cent to 33 per cent as a result of recently converted loans held with ADB valued at USD $23.3 million (Ports Authority loan of USD $13.3 million and Economic Recovery Support Program (ERSP) tranche one of USD $10 million) into NZD.

Gross Debt by Lenders

The estimated gross debt by lenders owed to the Crown at the end of November 2013.

Chart 3.12 Gross Debt Estimates by Lenders as at 30 November 2013



As illustrated in

Chart 3.12, the Crown has borrowing with three major creditors, the ADB holding 68 per cent followed by the Export Import bank of China (EXIM Bank) with 29 per cent and the Government of France holding three per cent.

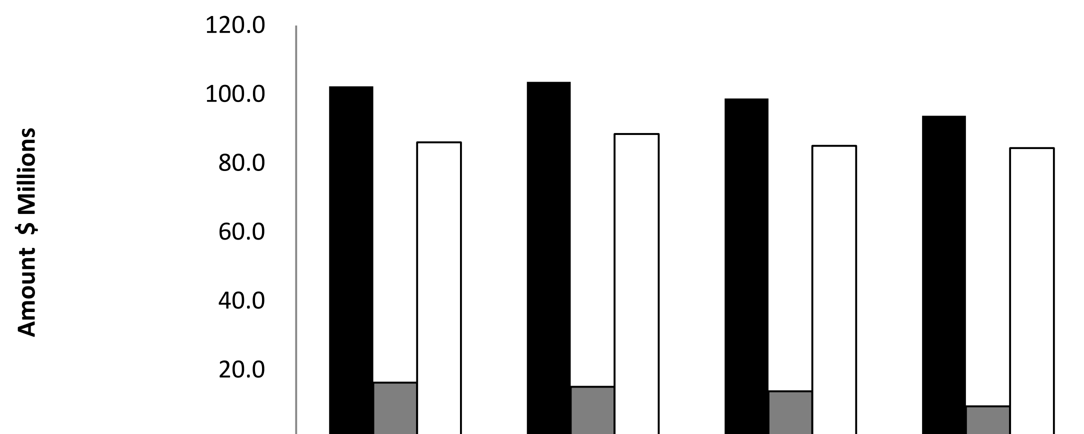
The EXIM bank share of the overall borrowing portfolio is estimated to increase to 34 per cent in 2014-15 fiscal year due to the final drawdown of $7.1 million planned to complete the Rarotonga water ring main project.

Government have not committed itself to further debt during the time of this write up.

3.3.2 Crown Debt burden

As it stands, total gross debt gradually reduces in the outer years as principle gets repaid, with the assumption that Government is not taking on new loans. The same indication is reflected on the Loan Reserve Fund (LRF) as it continues to reduce as the loans borrowed by the Crown on behalf of State Owned Enterprises (SOEs) are repaid.

Chart 3.13 Cook Islands overall debt burden



	2013/14	2014/15	2015/16	2016/17
■ Gross Debt	102.3	103.6	98.8	93.7
■ Loan Reserve	16.3	15.1	13.8	9.4
□ Net Debt Outstanding	86.0	88.5	85.0	84.4

3.3.3 Status of Government Loan

Table 3.6 shows that the amount estimated to be covered by the loan reserve fund for 2013-14 fiscal year is $13.8 million. The LRF currently has an estimated balance of $16.9 million, resulting in a net positive balance of $3.1 million.

This variance is the result of the overall net appreciation in the NZD against major exchange rates from 2010 to November 2013 described earlier in this chapter. In the event that the NZD weakened against these major exchange rates, this net balance will be used as a buffer to cover for exchange fluctuation in the outer years.

Table 3.6 Status of Government loans as at 30 November 2013

Loans drawn down	Date loan taken	Original loan amount (000)	Current balance (000) (NZD)	Expected date of repayment	Amount covered by loan reserve
ADB 461 (SD) Multi Project	November, 1980	SDR 1,000	643	August, 2020	0
ADB 567 (SD) CIDB Project	July, 1982	SDR 1,500	580	April, 2022	580
ADB 849 (SD) 2nd Multi-Project	December, 1987	SDR 2,067	2,023	August, 2027	2,023
ADB 1031 (SD) Outer Islands Telecom Project	October, 1990	SDR 3,541	4,726	August, 2030	4,726
ADB 1155 (SD) 2nd CIDB Project	March, 1992	SDR 939	1,186	December, 2031	1,186
ADB 1171 (SD) Emerg. Telecom Rehab Project	August, 1992	SDR 291	408	June, 2032	408
ADB 1309 (SD) Pearl Industry Dev. Project	December, 1994	SDR 336	448	August, 2034	0
ADB 1317 (SD) Educ'n Dev Project	Debruary, 1995	SDR 1,836	2,731	August, 2034	0
ADB 1380 (SD) 3rd CIDB Project	January, 1996	SDR 1,538	2,260	September, 2035	2,260
ADB 1466 (SD) Economic Restructure Program	September, 1996	SDR 3,430	4,993	September, 2036	0
ADB 1588 (SD) Cyclone Emergency Rehab Project	January, 1997	SDR 475	837	January, 2038	0
Restructured Drench Loans	January, 1999	Euro 5,413	2,652	September, 2018	2,652
ADB 1832 (SD) Waste Mgt Project	December, 2001	SDR 1,695	2,346	June, 2033	0
ADB 2174 (SD) Cyclone Emergency Assist Project	June, 2005	SDR 1,895	3,780	June, 2045	0
China - Multi-Functional Indoor Sports Stadium	August, 2008	RMB 74,100	13,732	August, 2028	0
ADB 2472 (OCR) Avatiu Port Development Project	September, 2009	NZD 10,309	10,309	November, 2033	0
ADB 2473 (SD) Avatiu Ports Development project	September, 2009	SDR 8,346	8,470	November, 2040	0
ADB 2565 OCR Economic Recovery Support Program 1	January, 2010	NZD 11,053	11,053	October, 2024	0
ADB 2739 (OCR) Amendment Avatiu Port project	December, 2011	NZD 5,614	5,614	November, 2035	0
China - Rarotonga Water Ring Main Upgrade	December, 2012	RMB 118,000	16,274	December, 2032	0
ADB 2565 OCR Economic Recovery Support Program 2	December, 2012	NZD 7,250	7,250	December, 2028	0
Total loans drawn down			**102,315**		**13,835**
Loans committed to but not yet disbursed					
China - Rarotonga Water Ring Main Upgrade	December, 2012	RMB 118,000	7,097	December, 2032	0
Total loans committed to but not yet disbursed			**7,097**		**0**
Total loans commitment			**109,413**		**13,835**

Chart 3.14 Current Bilateral and Multilateral Estimate Loans Outstanding Next 10 Years

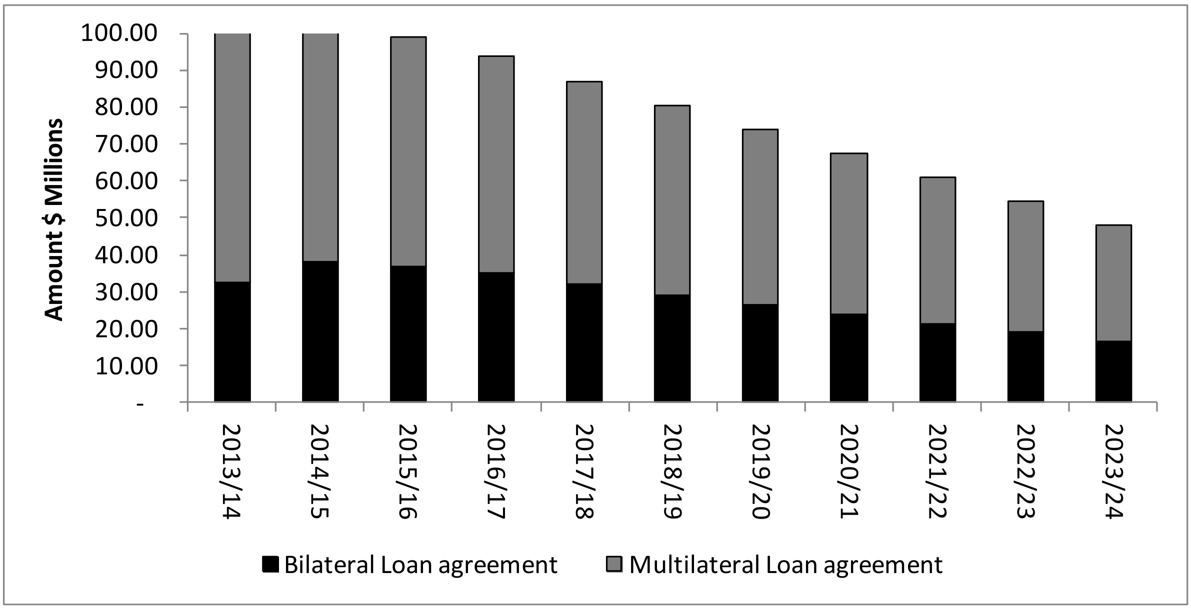


Chart 3.14 shows the bilateral and multilateral amount of borrowings to the Crown has on its record for the next 10 years from 2013/14 to 2023/24. The bulk of the debts are committed from multilateral agreements with the ADB, 68 per cent, compared to bilateral agreements of 29 per cent with the EXIM bank of China and three per cent with the Government of France.

3.3.4 Crown Loan Reserves (LRF)

The Crown LRF was established in 2001 to enable Government to access to concessional loans and provide these on to State Owned Enterprises (SOEs).

The payment terms with the external lenders which included a grace period of (normally five years) was not extended on to SOEs. SOEs have paid the full debt servicing cost from the initial drawdown of the loan.

In 2001 these funds were put aside into a debt reserve.

The overall objective of the trust fund is to build the total amount to a stage where it fully covers the outstanding amount owed to lenders from the SOE's.

As at the time of this publication, the objective was met with all SOE loans with Government being fully covered. These SOEs include the Bank of the Cook Islands, Te Aponga Uira, and Cook Islands Telecommunication.

The new loan approved for the Cook Islands Port Authority will be treated as a loan to Government from the ADB. The Cook Islands Port Authority is expected to repay and honour the same loan repayment schedule and terms agreed between the ADB and Government.

It is anticipated that the principle objective of the LRF will be extended beyond the SOE's to incorporate all Crown debt. The Government is currently investigating options to legislate the LRF and formalise the current debt management approach.

Table 3.7 Debt reserve transactions

Debt Reserve Working	Transfer In	Transfer Out	Balance	SOEs Debt
Budgets 2005-2006			17,018	
2006-07 transfer to reserve	1,529	0	18,547	22,390
2007-08 transfer to reserve	1,287	0	19,834	23,497
2008-09 transfer to reserve	1,100	0	20,934	21,018
2009-10 transfer to reserve	1,100	0	22,034	18,465
2010-11 loan repayment	0	1,529	20,505	17,365
2011-12 loan repayment	0	1,429	19,076	16,177
2012-13 loan repayment	0	1,529	17,547	12,541
2013-14 loan repayment	0	1,243	16,304	13,835
2014-15 loan repayment	0	1,243	15,061	12,592
2015-16 loan repayment	0	1,270	13,790	11,322

3.3.5 Net Debt

Net debt is the difference between the gross debt and monies held in the Crown LRF. Net debt is estimated to be $86.0 million (21.3 per cent of GDP) by the end of June 2014, an increase of $2.1 million since the 2013/14 budget and is predominantly due to the depreciation of the NZD against all major exchange rates reported earlier in this chapter.

Table 3.8 Estimated net debt to 2015/16

	2013/14 Proj	2014/15 Proj	2015/16 Proj	2016/17 Proj
Statement of Borrowings	$m	$m	$m	$m
Gross Crown Debt, End of FY	102.3	103.6	98.8	93.7
Net Crown Debt, End of FY	86.0	88.5	85.0	82.4
as percentage of GDP	21.3%	21.2%	19.7%	19.1%
Loan Repayment Reserves Held	16.3	15.1	13.8	11.3
Gross Debt Servicing	5.8	6.2	6.3	6.6
Net Debt Servicing	5.5	5.7	5.8	5.8
as percentage of Total Revenue	4.9%	4.9%	5.0%	5.0%

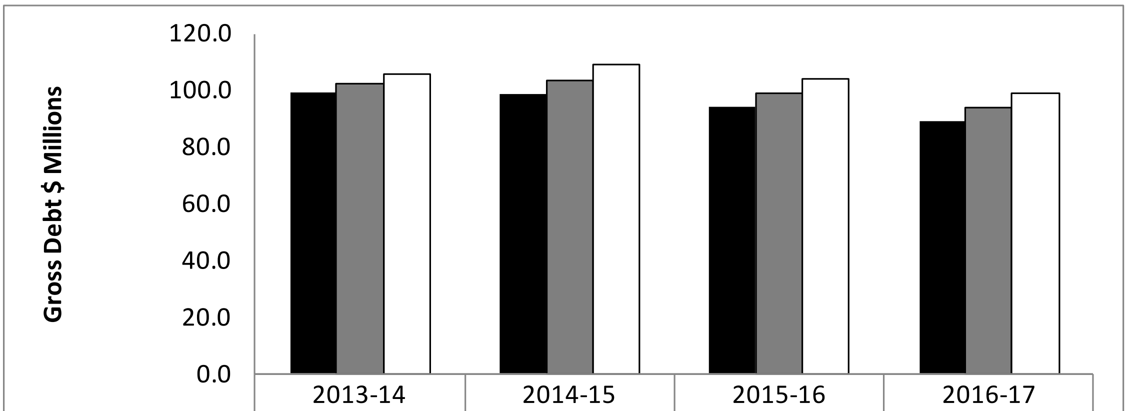
3.3.6 Crown Debt Sensitivity Analysis

Table 3.9 Base rate used for budget assumption with +/- five per cent

Foreign Exchange Currency	-5 per cent	Budget assumption base rate	+5 per cent
EUR	0.5819	0.6125	0.6431
USD	0.7852	0.8265	0.8678
RMB	4.7845	5.0363	5.2881
SDR	0.5074	0.5341	0.5608

The sensitivity analysis demonstrates the impact of a five per cent appreciation or depreciation in the New Zealand dollar is prepared to determine the impact on the gross borrowings and the debt servicing cost.

Chart 3.15 Sensitivity of Total Crown Gross Debt

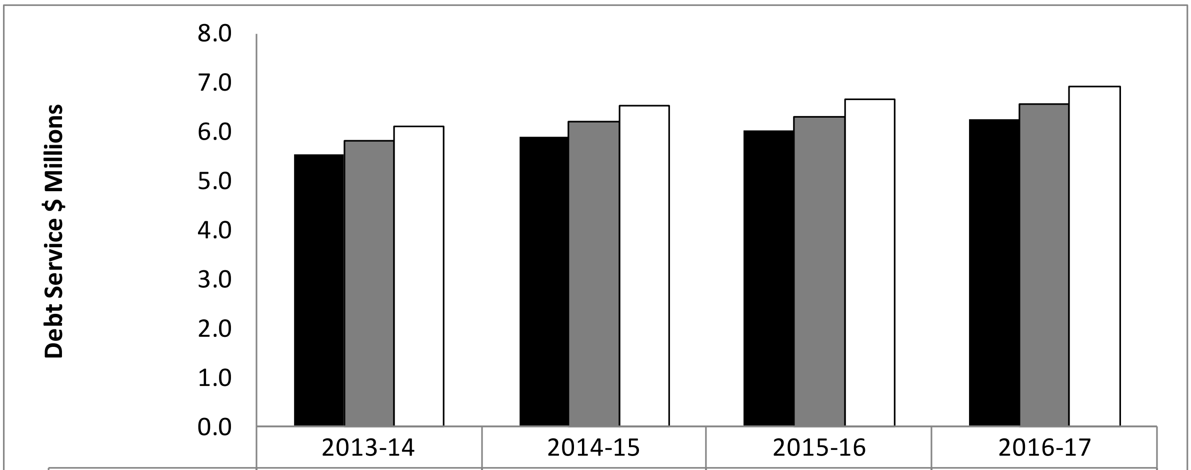


	2013-14	2014-15	2015-16	2016-17
Increase by 5%	99.1	98.6	94.1	89.3
Base Rate	102.3	103.6	98.8	93.7
Decrease by 5%	105.9	109.0	104.0	98.7

Total Crown debt increased by $5.4 million ($5.1 million during the time of the 2013-14 budget) compared to a reduction of $5 million ($4.5 million during 2013-14 budget) in 2014-15 as the impact of a five per cent depreciation/appreciation of the NZD. This reflects the depreciation of the NZD between the time of the 2013-14 budget and this write up which indicates that our loan portfolio is more sensitive to depreciation than appreciation in the NZD.

A continued depreciation of the New Zealand dollar beyond the five per cent scale reduces the opportunity for further borrowings and increasing debt servicing costs.

Chart 3.16 Sensitivity of Debts Servicing Costs



	2013-14	2014-15	2015-16	2016-17
Increase by 5%	5.5	5.9	6.0	6.2
Base Rate	5.8	6.2	6.3	6.6
Decrease by 5%	6.1	6.5	6.6	6.9

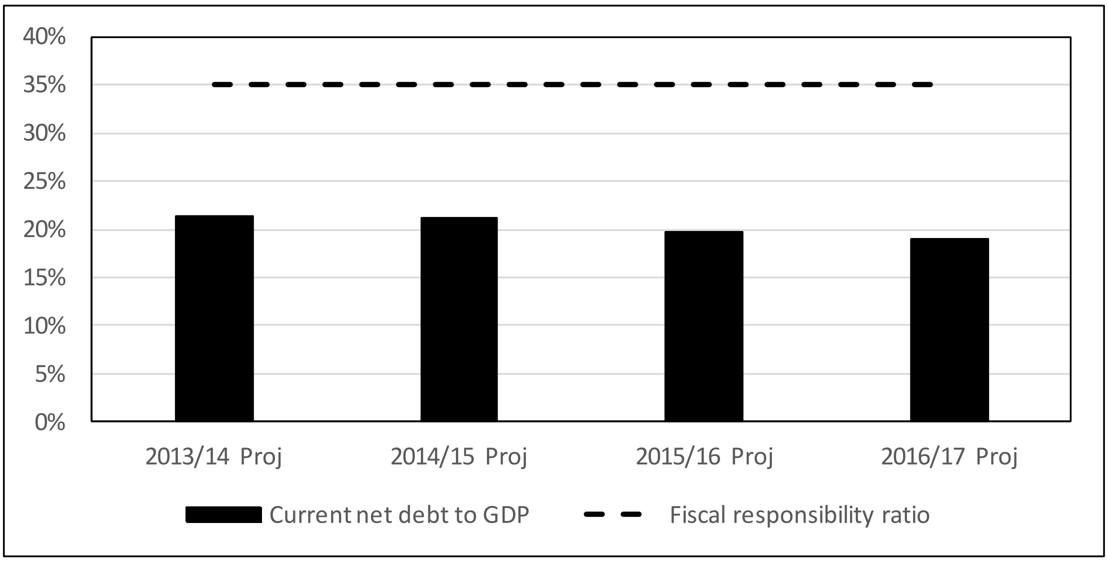
The impact of the five per cent increase or decrease on debt servicing cost is relatively consistent to the impact on gross debts.

Any decision to commit to further bowings should be assessed carefully due to the sensitivity of the New Zealand dollar.

3.3.7 Future Borrowings and Fiscal Responsibility Ratios relating to Debt

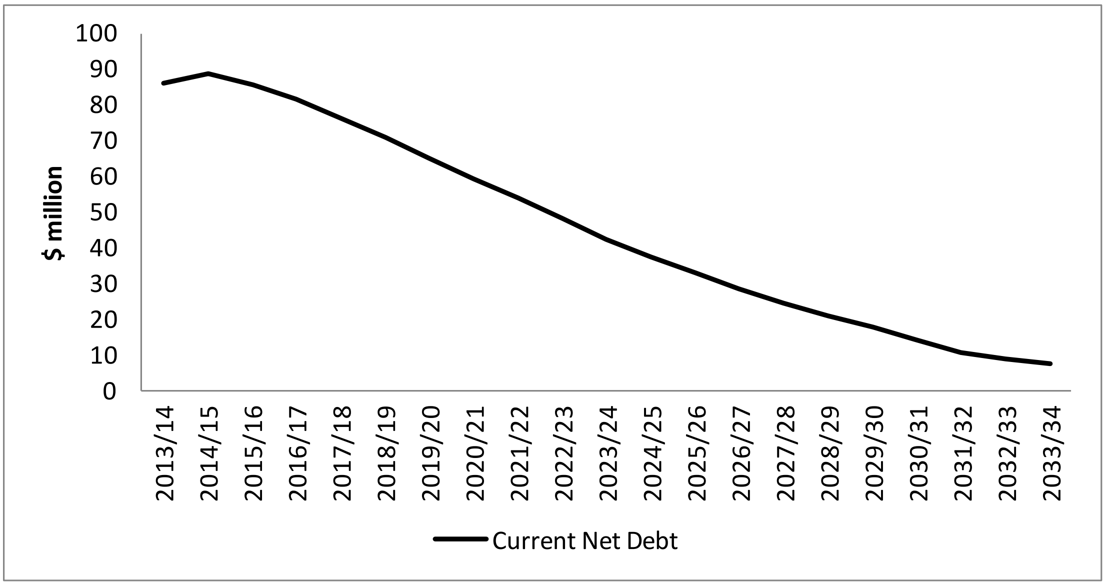
Proposals to take on new loans must be treated under transparent processes as required by the MFEM Act 1995/96. The fiscal responsibility ratios will prudently assist Government to manage the growth of its future borrowing plan.

Chart 3.17 Net Debt as a proportion of GDP



As can be seen from Chart 3.17, Government is well within its fiscal responsibility ratio threshold of 35 per cent.

Chart 3.18 Estimated net debt for next 20 years



However these ratios should not be looked at in isolation, any proposal to take on additional borrowing should be looked at in the context of whole of Government budget and its ability to pay annual debt servicing.

3.3.8 Net debt Service to Total Revenue

This ratio controls the servicing of debt. It primarily ensures that there are sufficient means to service debt from the operating revenue. Taken together with the tax revenue envelope, this ratio measures how much debt servicing is crowding out other components of government spending. Debt servicing includes interest and principal payments.

The benchmark for debt servicing to the total revenue ratio is not to exceed 5 per cent of the Crown total revenue. As reported in Chart 3.19, we do not have much room to move if Government decides to take on additional debt.

Chart 3.19 Net Debt as a proportion of Revenue

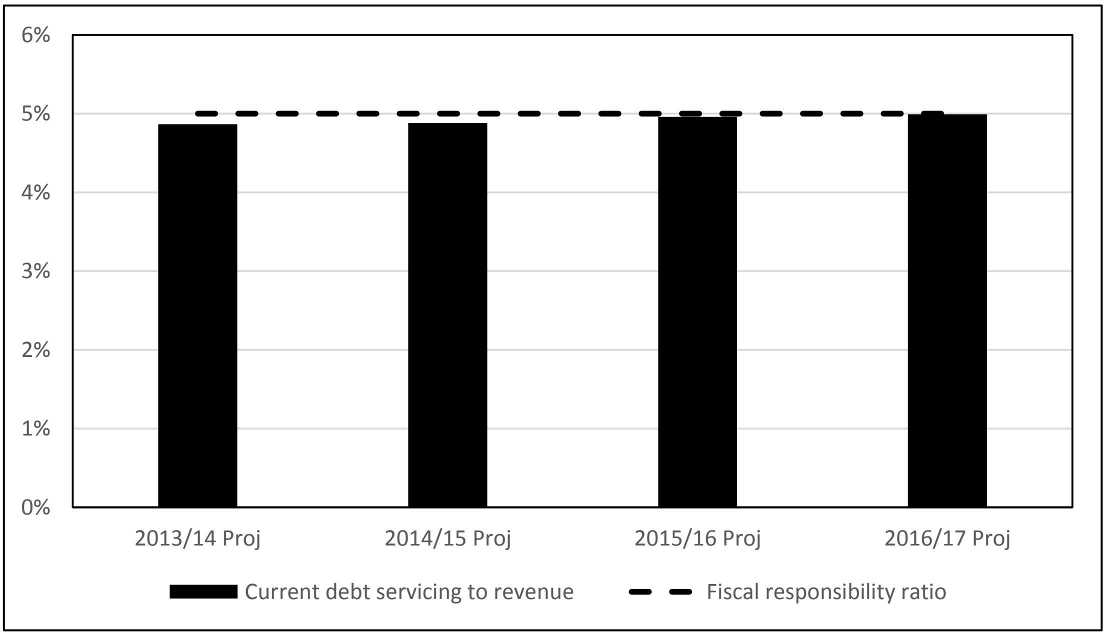
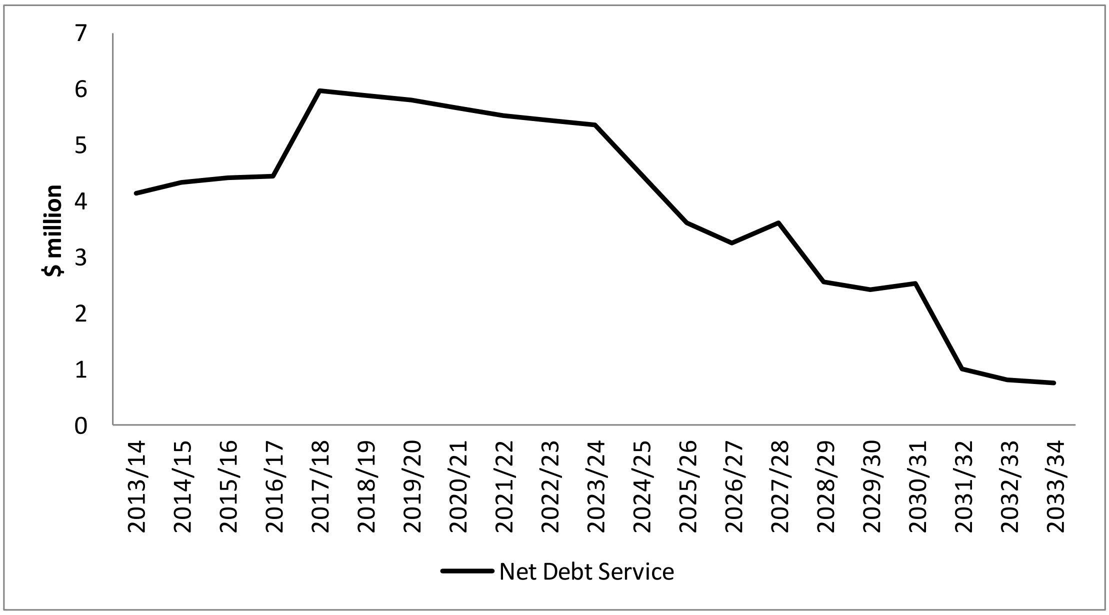


Chart 3.20 Estimated net debt service for next 20 Years



3.3.9 Other State Owned Enterprise Debt

State Owned Enterprises can take loans directly without Government guarantee, this analysis does not include those loans.

The Airport Authority reported in 2010-11 financial report that it had recently financed its loan with a new provider. The terms of the loan was for $8.1 million taken over a five year term with current interest rate at 5.54 per cent with a drawn amount of $7.3million.

The loan is repayable by monthly installments of $0.07 million which is inclusive of interest and is based on a 15 year amortization term with balloon payment at the end of term.

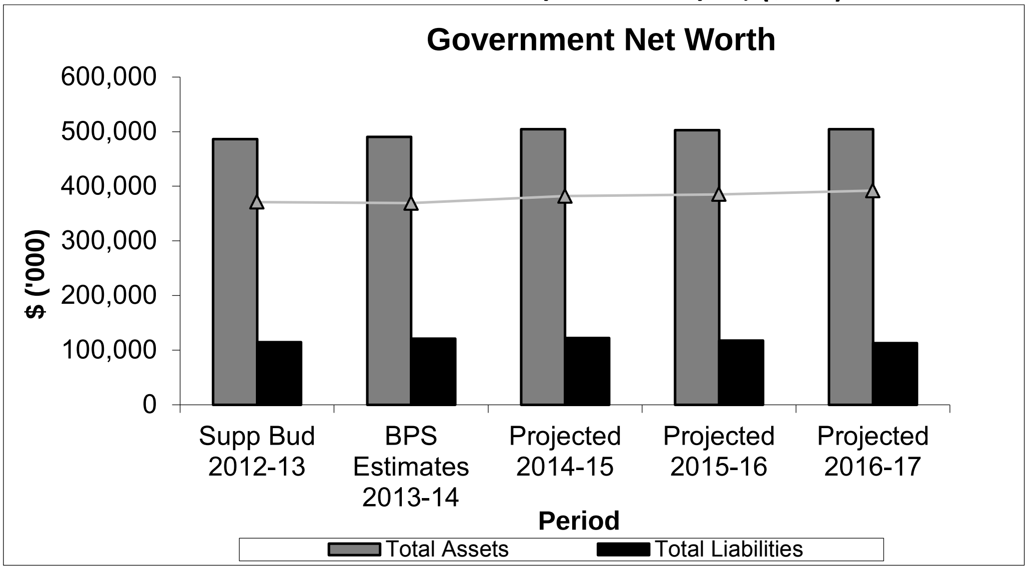
The loan is secured by registered mortgage debenture over the assets and undertakings of the Airport Authority. A financial covenant will apply where the amount of EBITDA generated less dividend paid will at all times be greater than twice the annual debt servicing commitments. The Covenant will be measured annually in arrears. The Airport Authority is considering additional borrowing of $23 million for further airport upgrades of Rarotonga International Airport.

Te Aponga Uira have also indicated they are considering new borrowings to finance new investments in electricity generation and supply assets including infrastructure aimed at improving renewable energy distribution and supply.

3.4 Net Worth

Government's net worth is the difference between Crown assets and Crown liabilities providing a snapshot of government's ability/inability to service all its creditors. There are currently no clear guides to determining an optimal level of public sector net worth; however analysing the government's net worth and what causes it to change can lead to understanding the need for appropriate policies.

Chart 3.21 Net Worth 2012/13 to 2016/17, ($000)



The estimated net worth of the Crown at June 2014 has decreased from the 2012/13 Supplementary Budget of $371.3 million to $369.1 million. This is a net movement of $2.2 million. This was a result of increases in the forecasted borrowings offset against increases in the Crown's physical assets.

The Crown's net worth will increase in the outer years from 2014/15 as long as there is an estimated operating surplus. Also a major contributor to the forecast upward trend is the decrease in borrowings, decrease in tax receivables and an injection to the Crown's asset from aid donor funding. It is estimated that an annual average of 10 per cent of donor funding is capital asset.

3.5 Overseas Development Assistance (ODA) Flows

Total ODA contribution from development partners was estimated at $59.4 million in the Budget 2013/14.

Major capital projects funded by ODA covering equipment (China grants in kind), water (Te Mato Vai, sanitation) and renewable energy have been progressing slowly in 2013/2014 with recent changes expected to lift results over the remaining 6 months.

Contracts have now been awarded for Te Mato Vai (Rarotonga water upgrade) with AECOM delivering the master plan and KEW contractors (Samoa) providing the project management unit to the Cook Islands government. The Cook Islands renewable energy program have seen reallocation of Japanese grants (PEC) from Northern Cook Islands to solar panel provision, reallocation of NZ/Australian funding to cover the installation costs and contracting of BECA to facilitate (tender, project manage, report) the installation of these solar systems.

Access to climate change financing opportunities continues to be complex and government continues to advocate for greater use of national systems to deliver climate finance and ODA programmes. MFEM has engaged the services of the Frankfurt School of Finance and Management to develop an application for National Implementing Entity status with the UN Adaptation Fund in 2014. To support this approach, on-going improvements are being made to the Government's public financial management, procurement and activity management systems.

Since July there have been some development partners committing additional funds or signalling changes. These are;

- In addition to a correction in accounting treatment by the EU in the FY 2013/14, the actual payment is now expected to be not later than April 2014. MFEM working on disbursal request using ADB economic assessment, Sanitation policy and 3 year plan. The amount remains unchanged at $1.6 million.
- $3.9m (20,000,000 RMB) pledge from the People Republic of China announced October 2013. To be channeled into the 2014/15 budget process for allocation.
- Changes to budget allocations due to cash flow needs of infrastructure projects within the three years Forward Aid Programme with New Zealand and Australia. With 18 months from the end of the current NZ government 3 year budget appropriation cycle these changes will be proposed in the 2013/14 supplementary and 2014/15 budget process. Overall priorities remain consistent plans and this is not expected to result in a change to the total 3 year contribution.
- Australia granted an additional $37,780 to assist fund the SPC's 12th triennial conference on Pacific Women held in October 2013 in Rarotonga.

Some development partners have also indicated emerging funding opportunities. These are;

- Small Island States Fund (regional managed by PIFS). Previously only Taiwan supporting fund and amount limited, the Cook Islands have used funds to top up the emergency disaster fund. PIFS wanting to reshape fund purpose with link to the Forum compact work (development effectiveness). PIFS have projected $200,000 USD over 3 years for CI but funding an issue. Support from PICs important to secure funds.
- France has allocated $100,000 for Renewable Energy monitoring system in Northern Cook Islands. A concept note has been submitted to the French government for consideration.
- New Caledonia grant proposed for Renewable Energy in Aitutaki, $700,000 NZD. REDD following up with OPM to clarify proposal.
- ADB will be making an application on behalf of the Cook Islands for $6.5 million NZD from EU energy sector fund which is proposed to be blended with projected ADB lending and existing NZ/A funding from 2014/15.

The Pacific Islands Forum Secretariat undertook a Peer review of the Cook Islands national development planning and budget processes in October 2013 to:

- promote international best practice in key sectors,
- improve effective budget allocations and implementation to achieve national development priorities; and
- guide support from development partners.

The objective of the peer review process is to guide improvements in development coordination, including by informing discussions at the Pacific Islands Forum and Post Forum Dialogue, through reviews of coordination at a country level. The preliminary report is available on www.mfem.gov.ck. The peer review recommended a transition of the relationship between donors and the Cook Islands government from ''financial and administrative discussions to bigger picture policy dialogue''. The key findings in relation to the management of ODA include;

- Support for the move away from project based approaches and towards sector based or budget support
- High rates of staff turnover
- Need for greater information and accountability for regional ODA flows.
- Need to clarify mandates of ministries and government structures
- Increase in joint analysis, missions and pooled funds between donors and the CI government.
- Improved DCD review and quality control practices which are understood and endorsed by line ministries.

In addition, a PEFA self-assessment was undertaken in parallel with the peer review and with the assistance of IMF PFTAC. This has provided an additional level of insight into the public financial management capacity across the Cook Islands government. Based on these results, the 2014 formal PEFA assessment is expected to act as a catalyst for donors to increase the use of national systems.

The Government continues to foster partnerships with local and international partners with the development partners meeting scheduled for 11-13th February 2014. The meeting will allow government to present forward priorities, update progress and identify new pledges to inform the national budget process starting in April 2014.

3.6 Specific Financial Risks

The total quantifiable contingent liabilities are estimated at $18.0 million in 2013/14. This is made up of the following:

3.6.1 Guarantees and Indemnities

The Government has entered into a program under the New Zealand Aid Programme focused on Pearl Sector Support run through the Cook Islands Pearl Authority. Through the program the CIG has agreed to guarantee up to $0.5 million as security for loans associated with the Pearl Production Credit Scheme. The full guarantee has been included as a contingent liability. There has been no change since the time of the 2013/14 Budget Estimates.

3.6.2 Uncalled Capital

The Government also holds $1.4 million in the Asian Development Bank - Cook Islands Government Property Corporation. This takes the form of 88 uncalled shares with a par value of US$13,500 each.

3.6.3 Legal Proceedings and Disputes

Total quantifiable risk to the Crown under legal proceedings and disputes is $16.1 million.

$14.5 million relates to contingency in recognition of the lawsuit filed against the government regarding its shipping policy in October 2002.

$1.6 million in relation to smaller legal claims against government departments, namely Police and Health.

3.7 Assumptions Underlying the Fiscal Projections

Various assumptions must be made to forecast government's fiscal performance and position in the outer years.

- Operating Revenues are forecasted on the basis of recent trends in economic activity as well as one off considerations.
- GDP and trade data is updated to the 2012 calendar year while all other data is updated to the June or September quarters of 2013, except for tourism arrivals, which include the October arrival numbers. The data sets used were those available as at 11 December 2013.
- Nominal GDP is expected to grow by:
  - 3.7 per cent in 2012/13
  - 5.0 per cent in 2013/14
  - 2.3 per cent in 2014/15
  - 0.6 per cent in 2015/16
- The general model used to forecast nominal economic growth is based on the expenditure national accounting measure and uses estimates of public final demand (including aid assistance), net merchandise trade, tourism total spending, investment, and domestic consumption.
  - Tourism expenditure is the largest single component of the forecasts, and is based on:
    - An average stay of 7.9 days for New Zealand arrivals, 8.4 for Australia, 7.4 for USA, 8.8 for Canada, 8.6 for the UK and Europe, 6.2 for Asia, and 7.9 for other – an overall average of around 8.0 days depending on the composition of total arrivals in any given month. This data was collected from the Customs and Immigration database of arrivals and departures, which uses the passport numbers of visitors to determine how long an individual passport holder is in the country.
    - Average visitor spend of NZD 227.00 per day, which is estimated from quarterly visitor surveys and a CPI indexation of a basket of tourist services.
  - Public final demand is the second largest single item and is estimated based on the personnel and operating appropriation, as well as the capital expenditure profile, for both Government and aid spending. A realisation (or completion) rate is applied to capital projects to allow for project slippage from one year to the next. This rate sits between 40 per cent and 50 per cent, depending on the year.
    - Government expenditure is based on the Operating Estimates for 2012/13, Appropriation for 2013/14, and existing government policy, and is expected to grow as follows:
      - 8.2 per cent in 2011/12
      - 1.8 per cent in 2012/13
      - 2.1 per cent in 2013/14
      - 0.8 per cent in 2014/15
- Growth in prices measured through movements in the Consumer Price Index to remain around the historical yearly averages, with a small increase in inflation in 2013/14 due to the 2.5 percentage point increase to the VAT. Inflation is forecast to be:
  - 2.6 per cent in 2012/13
  - 4.6 per cent in 2013/14
  - 2.9 per cent in 2014/15
  - 3.1 per cent in 2015/16
- Operating Expenditure movements in the outer years are based on actual commitments to movements through the Medium Term Budgeting Framework.
- The level of borrowings is based on average exchange rates in December 2012.

4 FINANCIAL STATEMENTS

Financial Statements for BPS
As at 30 June 2014

The forecasted financial estimates of the Crown are set out on the following pages.

(1) Statement of Financial Performance

(2) Statement of Financial Position

(3) Statement of Cash flows

(4) Statement of Borrowings

(5) Summary of Revenue Levied on Behalf of the Crown

(6) Statement of Financial Risks

4.1 Statement of Financial Performance

For the years ending 30 June 2014

	Supp Bud 2012-13 ('000)	BPS Estimate 2013-14 ('000)	Projected 2014-15 ('000)	Projected 2015-16 ('000)	Projected 2016-17 ('000)
Revenue					
Taxation revenues	94,971	98,942	104,209	104,598	109,326
Other revenue					
Revenue on behalf of the Crown	6,780	8,756	8,808	8,790	8,789
Sale of goods and services	5,209	5,452	6,014	6,051	6,051
Interest	2,027	2,147	2,171	2,195	2,195
Dividends	2,240	2,561	2,415	2,396	2,396
Total Revenue	***111,227***	***117,858***	***123,616***	***124,029***	***128,758***
Expenditure					
Appropriations to agencies	61,533	63,591	65,812	65,867	65,867
Payments on behalf of Crown	42,389	44,097	46,086	46,301	46,301
Debt-servicing interest	1,368	1,429	1,520	1,283	1,283
Building maintenance	1,800	1,800	1,800	1,800	1,800
Infrastructure depreciation	3,478	5,070	6,904	6,904	6,904
Other expenditure	3,155	3,834	2,680	2,679	2,679
Total Expenditure	***113,723***	***119,821***	***124,802***	***124,834***	***124,834***
NET OPERATING SURPLUS / (DEFICIT)	***-2,496***	***-1,963***	***-1,186***	***-805***	***3,924***

4.2 Statement of Financial Position

As at 30 June 2014

	Supp Bud 2012-13 ('000)	BPS Estimates 2013-14 ('000)	Projected 2014-15 ('000)	Projected 2015-16 ('000)	Projected 2016-17 ('000)
Assets					
Cash and equivalents	21,329	14,421	12,613	23,205	38,787
Loan reserves	16,310	16,300	15,060	13,790	11,320
Trust accounts	8,013	8,511	9,018	9,533	10,048
Inventory	4,395	4,395	4,395	4,395	4,395
Tax receivables	16,647	16,944	16,713	16,480	15,986
Debtors and other receivables	10,699	10,699	10,699	10,699	10,699
Advances to SOEs	27,492	24,393	24,230	23,918	23,398
Investment in SOEs	146,733	146,733	146,733	146,733	146,733
Plant, property, and equipment	234,447	247,943	265,038	254,116	243,194
Total Assets	***486,065***	***490,340***	***504,498***	***502,869***	***504,560***
Liabilities					
Creditors and other payables	10,909	10,412	9,907	9,393	8,879
Trust liabilities	8,013	8,510	9,015	9,529	10,043
Borrowings	95,883	102,320	103,570	98,800	93,740
Total Liabilities	***114,805***	***121,242***	***122,492***	***117,722***	***112,662***
Net Crown Balance	***371,260***	***369,098***	***382,006***	***385,147***	***391,898***

4.3 Statement of Cashflows

For the years ending 30 June 2014

	Supp Bud 2012-13 ('000)	BPS Estimate 2013-14 ('000)	Projected 2014-15 ('000)	Projected 2015-16 ('000)	Projected 2016-17 ('000)
Cashflows from Operating Activities					
Cash provided from:					
Taxation and levies	94,971	98,942	104,209	104,598	109,326
Collection of tax arrears	972	-297	231	233	494
Sale of goods and services	5,209	5,452	6,014	6,051	6,051
Interest	2,027	2,147	2,171	2,195	2,195
Dividends	2,240	2,561	2,415	2,396	2,396
Other income	6,780	8,756	8,808	8,790	8,789
	112,199	*117,561*	*123,847*	*124,262*	*129,252*
Cash applied to:					
Appropriations to agencies (less depn)	58,048	59,704	61,849	61,849	61,849
Payments on behalf of Crown	42,389	44,097	46,086	46,301	46,301
Debt-servicing interest	1,368	1,429	1,520	1,283	1,283
Building maintenance	1,800	1,800	1,800	1,800	1,800
Other expenditure	5,929	4,331	3,185	3,193	3,193
	109,534	*111,361*	*114,440*	*114,426*	*114,426*
Net Operating Activity Cashflows	***2,665***	***6,200***	***9,407***	***9,836***	***14,826***
Cashflows from Investing Activities					
Cash provided from:					
Subsidiary loan repayments	0	0	0	0	0
	0	*0*	*0*	*0*	*0*
Cash applied to:					
Capital expenditure	23,743	16,517	24,383	0	0
Advances to Subsidiaries	0	0	0	0	0
	23,743	*16,517*	*24,383*	*0*	*0*
Net Investing Activity Cashflows	***-23,743***	***-16,517***	***-24,383***	***0***	***0***
Cashflows from Financing Activities					
Cash provided from:					
Loans drawn down	16,399	6,946	16,946	0	0
Cash drawn from loan reserves	1,529	1,243	1,243	1,270	1,270
	17,928	*8,189*	*18,189*	*1,270*	*1,270*
Cash applied to:					
Loan repayments	3,416	4,281	4,515	0	0
Loan reserves	0	0	0	0	0
Other reserves	743	498	507	514	514
	4,159	*4,779*	*5,022*	*514*	*514*
Net Financing Activity Cashflows	***13,769***	***3,410***	***13,167***	***756***	***756***
Net cash movements	-7,309	-6,907	-1,809	10,592	15,582
Add: Opening Cash and Equivalents	28,638	21,329	14,421	12,613	23,205
Closing Cash and Equivalents	***21,329***	***14,421***	***12,613***	***23,205***	***38,787***

4.4 Statement of Borrowings

As at 30 June 2014

	Supp Bud 2012-13 ('000)	BPS Estimate 2013-14 ('000)	Projected 2014-15 ('000)	Projected 2015-16 ('000)	Projected 2016-17 ('000)
Total Gross Borrowings	***95,883***	***102,320***	***103,570***	***98,800***	***93,740***
Assets Held Against Borrowings:					
Advances to subsidiaries	27,492	24,393	24,230	23,918	23,398
Loan reserves	16,310	16,300	15,060	13,790	11,320
Total Assets Held Against Borrowings	***43,802***	***40,693***	***39,290***	***37,708***	***34,718***
Net Borrowings of the Government	***52,081***	***61,627***	***64,280***	***61,092***	***59,022***

Note: The Crown debt balances in section 3.3 does not take into consideration the advances to State Owned Enterprises (SOEs) as Government is the guarantor of the loan and is obligated to loan repayments regardless of SOEs
meeting their repayment obligations to Government.

4.5 Revenue Levied on Behalf of the Crown

For the years ending 30 June 2014

	Supp Bud 2012-13 ('000)	Projected 2013-14 ('000)	Projected 2014-15 ('000)	Projected 2015-16 ('000)	Projected 2016-17 ('000)
Taxation					
Income tax	26,201	22,304	21,285	21,951	22,920
Company tax	11,001	12,136	12,240	12,308	12,707
Import levies	13,038	15,201	15,148	14,170	15,754
Departure tax	6,481	6,872	7,244	7,640	8,030
VAT	37,350	41,529	48,291	48,528	49,916
Withholding tax	900	900	0	0	0
Total Revenue Levied on Behalf of the Crown	***94,971***	***98,942***	***104,209***	***104,598***	***109,326***

4.6 Statement of Fiscal Risks

As at 30 June 2014

	('000)
Quantifiable Contingent Liabilities	
Guarantees and indemnities	500
Uncalled capital	1,435
Legal proceedings and disputes	16,078
Total Quantifiable Contingent Liabilities	***18,013***

Guarantees and indemnities relate to the following:
Government has entered into a program under the New Zealand Aid Programme focused on Pearl Sector Support run through the Cook Islands Pearl Authority. Through the program the Government has agreed to guarantee up to $0.5million as security for loans associated with the Pearl Production Credit Scheme. The full guarantee has been included as a contingent liability.

Uncalled capital relates to shares in the Asian Development Bank - Cook Islands Government Property Corporation owns 88 uncalled shares with a par value of US$13,500 each.

Legal proceedings and disputes relate to current cases against the Crown.

4.7 Statement of Accounting Policies

There have been no changes since the Budget Policy Statement 2013/14. There are no major changes to accounting policies anticipated in the foreseeable future.

4.7.1 Basis of Preparation

Reporting Entity

These financial statements are for the Government of the Cook Islands. These consist of:

- Ministers of the Crown
- Ministries
- Island Administrations
- Offices of Parliament
- Public Enterprises and Other Authorities

A schedule of the entities included in these financial statements is detailed on page 23.

Statement of Compliance

These financial statements have been prepared in accordance with the Ministry of Finance and Economic Management Act 1995-96 and with the International Public Sector Accounting Standards issued by the International Public Sector Accounting Standards Board (IPSASB).

Measurement Base

The financial statements have been prepared on the going concern assumption and the accounting policies have been applied consistently throughout the period except where stated elsewhere in this Statement of Accounting Policies.

These financial statements have been prepared using the historical cost method to report results, cash flows and the financial position of the Crown. The financial statements have been prepared under the accrual basis of accounting and are presented in New Zealand dollars rounded to the nearest thousand dollars.

4.7.2 Significant Accounting Policies

The following accounting policies, which significantly affect the measurement of financial performance, financial position and cash flows, have been applied:

Recent Standards

Of significant relevance to the Crown is the recent development of new standards at the IPSASB. These include:

	STANDARDS	EFFECTIVE DATE
A.	IPSAS 25 Employee Benefits	1/01/2011

B.	IPSAS 26 Impairment of Cash Generating Assets	1/04/2009
C.	IPSAS 27 Agriculture	1/04/2011
D.	IPSAS 28 Financial Instruments: Recognition and Measurement	1/01/2013
E.	IPSAS 29 Financial Instruments: Presentation	1/01/2011
F.	IPSAS 30 Financial Instruments: Disclosure	1/01/2013
G.	IPSAS 31 Intangible Assets	1/04/2011

These new standards have been issued but are not yet effective for the consolidated Crown accounts as the preparation of the 30 June 2010 accounts are currently in progress – the 30 June 2009 consolidated accounts were completed and audited on 24 May 2012. The Crown will have to consider these new standards in future years. Crown has not yet determined the effect of these new standards.

Basis of Consolidation

The Government Ministries, Public Enterprises and Other Authorities (including State Owned Enterprises (SOEs)) comprising the reporting entity are consolidated involving addition of like items of assets, liabilities, revenues and expenses on a line by line basis.

The effect of all material inter-entity transactions and balances are eliminated on consolidation.

Commitments and contingent liabilities of Public Enterprises and Other Authorities are reported in the Statements of Commitments and of Contingent Liabilities.

Associate

An associate is an entity over which the Crown has significant influence where the entity is neither a subsidiary nor an interest in a joint venture. Investment in an associate is recognised at cost and the carrying amount is increased or decreased to recognise the Crown's share of the surplus or deficit after the date of acquisition. When the Crown transacts with an associate, all surplus and deficits related to the Crown are eliminated. Distributions received from an associate reduce the carrying value of the investment in the Crown Financial Statements.

Revenue

Revenue is measured at fair value of the consideration received or receivable.

Revenue Levied through the Crown's Sovereign Power

Payment of tax does not of itself entitle a taxpayer to an equivalent value of services or benefits; such revenue is received through the exercise of the Crown's sovereign power. Revenue arising through taxes is recognised when the taxable event occurs and when the criteria for recognition of an asset are met.

Revenue Type	Revenue Recognition Point
Individual Income Tax	When an individual earns income that is subject to PAYE or provisional tax. This also includes withholding taxes.
Company Income Tax	When the corporate community earns taxable income.
Value Added Tax	When the liability to the Crown is incurred. For example, the liability arising from sales in June being paid in July however recognised as revenue in June.
Customs levies	When goods liable to duty are assessed, except for Oil Companies which are accounted for when the liability to the Crown is incurred.
Departure Tax	When departure tax coupons are purchased.
Other Revenue	When the debt to the Crown arises.

Revenue Earned Through Operations

Revenue from sales of goods is recognised when the product is sold to the customer.

Fines

Fines are economic benefits or services potential received by the Crown from an individual or other entity, as determined by a court or other law enforcement body, as consequence of the individual or other entity breaching the requirements of laws and regulations.

Investment Income

Investment income is recognised in the period in which it is earned.

Gains

Realised gains arising from sale of assets or from the early settlement of a liability are recognised in the Statement of Financial Performance in the period in which the transaction is concluded.

Dividends

Dividends are recognised when the right to receive the payment has been established.

Aid Revenue

Revenue is recognised when donor funds are expensed on approved projects.

Expenses

Expenses are recognised when incurred and are reported in the financial period to which they relate.

Welfare Benefits

Welfare benefits are recognised in the period which the payment of these benefits relates to.

Grants and Subsidies

Where grants and subsidies are discretionary until payment, the expense is recognised when the payment is made. Otherwise, the expense is recognised when the specified criteria have been fulfilled and notice has been given to the Crown.

Losses

Realised losses arising from sales of assets or the early settlement of a liability are recognised in the Statement of Financial Performance in the period in which the transaction is concluded.

Foreign Currencies

Transactions in foreign currencies are translated into New Zealand dollar using the exchange rate on the date of the transaction. Foreign exchange gain and losses arising from these transactions are included in the Statement of Financial Performance.

Any monetary assets and monetary liabilities held at year end are translated at the exchange rate at the balance sheet date.

Aid Expenses

Expenses are recognised when incurred on approved projects and are reported in the financial period to which they relate.

Depreciation

Each part of an item of plant, property, and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

Depreciation of plant, property, and equipment is provided on a straight line basis so as to allocate the cost of assets to their estimated residual value over their estimated useful lives. Typically, the estimated useful lives are:

Office and computer equipment	3 – 4 years
Motor vehicles	5 years
Furniture and fittings	4 – 10 years
Plant and Equipment	5 – 15 years
Buildings and improvements	10 years
Coastal protection	25 years
Power distribution network	20 years
Roading network	30 years
Water network	15 years
Airport runways	15 – 100 years
Harbour and ports structures	10 – 20 years
Waste management facilities	15 years

Non-Current Assets

Plant, Property, and Equipment

Plant, property and equipment are recorded at cost less accumulated depreciation.

The cost of purchased plant, property, and equipment is the value of the consideration given to acquire the assets and the value of other directly attributable costs which have been incurred in bringing the assets to the location and condition necessary for their intended service.

The cost of assets constructed by the Crown includes the cost of all materials used in construction, direct labour on the project, financing costs that are directly attributable to the project and an appropriate proportion of variable and fixed overheads. Costs cease to be capitalised as soon as the asset is ready for productive use and do not include any inefficiency costs.

Disposals

When an item of plant, property and equipment is disposed, the gain or loss (disposal proceeds less carrying value) associated with that item will be recognised in the Statement of Financial Performance.

Additions

The cost of an item of plant, property and equipment is recognised as an asset if, and only if, there will be future economic benefits evident and where these benefits will flow to the Crown and the cost of the item can be measured reliably.

Work in Progress

Work in Progress is recognised as cost less impairment and is not depreciated.

Infrastructure Assets

Infrastructure assets are recorded at cost less accumulated depreciation.

The cost of purchased infrastructure assets is the value of the consideration given to acquire the assets and the value of other directly attributable costs which have been incurred in bringing the assets to the location and condition necessary for their intended service.

The cost of assets constructed by the Crown includes the cost of all materials used in construction, direct labour on the project, financing costs that are directly attributable to the project and an appropriate proportion of variable and fixed overheads. Costs cease to be capitalised as soon as the asset is ready for productive use and do not include any inefficiency costs.

Infrastructure assets include: roading networks, water networks, power distribution networks, coastal protection systems, harbour and ports structures and waste management and airport assets.

IPSAS 17 allows a choice of accounting model for an entire class of property, plant and equipment. The Crown has changed the accounting policy from the cost to revaluation model for the following classes of assets:

- Power network
- Harbours & ports
- Airports

These assets are now carried at re-valued amounts which are the fair value at revaluation date less subsequent depreciation and impairment losses.

When an infrastructure asset is disposed of, the gain or loss (disposal proceeds less carrying value) associated with that item will be recognised in the Statement of Financial Performance.

Work in Progress is recognised as cost less impairment and is not depreciated.

Intangible Assets

Intangible assets are software acquisition costs.

Intangible assets are recorded at cost less accumulated amortisation.

The cost of purchased intangible assets is the value of the consideration given to acquire the assets and the value of other directly attributable costs which have been incurred in bringing the assets to the location and condition necessary for their intended service.

Intangible assets might include: databases, software purchased, or software developed.

When an intangible asset is disposed of, the gain or loss (disposal proceeds less carrying value) associated with that item will be recognised in the Statement of Financial Performance.

Amortisation of intangible assets is on a straight line basis so as to allocate the cost of assets to their estimated residual value over their estimated useful lives. Typically, the estimated useful lives are:

Software, databases: 3 - 5 years

Cash and Cash Equivalents

Cash and cash equivalents includes cash on hand, deposits held at call with banks, other short term highly liquid investments with original maturities of three months or less and bank overdrafts.

Receivables and Advances including Debtors and Other Receivables

Receivables and advances are recorded at cost.

After initial recognition, loans and receivables are measured at amortised cost less any provision for impairment. Gains and losses when assets are impaired or derecognised are recognised in the statement of financial performance.

Inventories

Inventories held for distribution or consumption in the provision of services that are not supplied on a commercial basis is measured at cost. Where inventories are acquired at no cost of for nominal consideration, the cost is the current replacement cost at the date of acquisition.

Inventories held for use in the production of goods and services on a commercial basis are valued at the lower of cost and net realisable value.

Investments

Investments in associate are accounted in the consolidated financial statements using the equity method. That is, investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the Crown's share of the surplus or deficit of the associate after the day of acquisition.

Banking portfolio investments

Loans are valued at net realisable value after provisions. Applicable security is obtained depending on the size and nature of loans. Non-performing loans are reviewed monthly on a case by case basis.

Provision for doubtful debts

Provision is made for taxation debt where recovery is considered doubtful. There is no general provision against taxation debt.

Provision is made for banking portfolio Investments (specific loans) where recovery is considered doubtful or they have become non-performing. There is no general provision against banking portfolio Investments.

All bad debts are written off against specific provisions in the period in which they become classified as irrecoverable.

Aid Assets

Donor funds are deposited into bank accounts until expensed on approved assets.

Liabilities

Borrowings

Borrowing liabilities are accounted for at amortised cost. Any changes are recognised in the Statement of Financial Performance.

Pension Liabilities

Pension liabilities, in respect of the contributory service of current and past Members of Parliament, are recorded at the latest (30th June 1997) actuarial value of the Crown's liability for pension payments. There are no pension liabilities accruing to the Crown as a result of Government employees' membership of the Government Superannuation Fund (New Zealand).

Employee Entitlements

These include salaries and wages accrued up to balance date, annual level earned but not yet taken at balance date. A long service bonus is paid out on the completion of 3 years continuous service within the Government. The bonus is equivalent to a fortnight pay of the employee.

Other Liabilities

All other liabilities are recorded at the estimated obligation to pay. No liability for ongoing welfare payments has been recognised because no legal entitlement is considered to exist beyond the end of the current financial year until a new Appropriation Act is passed.

Aid Liabilities

Funds received from various donors are treated as liabilities until expensed on approved projects at which stage the funding is included within the Statement of Financial Performance as revenue.

Cash Flow

A cash flow statement identifies the sources of cash inflow, the items on which cash was utilised and the cash balance at the reporting date for Crown. Included in the cash flow statements are financing activities which are activities that result in the change of size and composition of the contributed capital and borrowings of the Crown. Investing activities are the acquisition and disposal of long term assets and other investments and operating activities identifies how much the Crown received from its actual operations.

Cash flow information allows users to ascertain how the Crown raised the cash it required to fund its activities and the manner in which that cash was utilised.

Leases

Finance leases transfer, to the Crown as lessee, substantially all the risks and rewards incidental on the ownership of a leased asset. The obligations under such leases are capitalised at the present value of minimum lease payments. The capitalised values are amortised over the period in which the Crown expects to receive benefits from their use.

Operating leases, where the lessors substantially retain the risks and rewards of ownership, are recognised in a systematic manner over the term of the lease.

The cost of leasehold improvements is capitalised and amortised over the lesser of the leasehold improvements useful life or the original lease term.

Commitments

The Statement of Commitments discloses those operating and capital commitments arising from non-cancellable contractual or statutory obligations. Interest commitments on debts and commitments relating to employment contracts are not included.

Contingent Liabilities

Contingent liabilities are recorded when a possible obligation has arisen from an event in the past and which the existence will only be confirmed through the occurrence or non-occurrence of future events. Such liabilities will be disclosed if they are deemed to materially affect the reading of the presented financial statements.