# Survival and Cash Management Strategy (SCMS)

## Background and Context

The Cook Islands' economy has faced the largest negative shock in the history of the nation, and without appropriate use of fiscal policy risks severe and permanent effects to incomes and the standard of living in the Cook Islands. The Cook Islands Government is carefully balancing the return of the economy to pre-covid levels ($550 million p.a. in nominal Gross Domestic Product (GDP)) through the Economic Recovery Roadmap (ERR) against the growth of debt and the impact servicing this debt has on the cash position.

The objective of the Survival and Cash Management Strategy (SCMS) is to mitigate fiscal risks faced by government in the short-term due to the high degree of uncertainty resulting from the pandemic. The government will achieve this by;

- Implementing ERR policies that will accommodate both contingency and recovery, driving the economy back toward the level prior to the pandemic;
- Setting short term policy targets (12 months) using the MTFS to manage
    - General Cash Reserves
    - Debt to GDP target
- Setting cash management strategy to mitigate liquidity risks

### 1. Economic Recovery Roadmap

The Economic Recovery Roadmap (ERR) is focused on re-growing GDP to $550 million p.a. as quickly as possible. Our private sector is reliant on GDP recovery to assist stimulating demand for goods and services and ultimately business profitability. The public sector relies on it because it is directly proportional to government revenues through taxes, and lower taxes results in only two choices in the medium term- (i) increase debt, or (ii) reduce Government expenditure. Neither of these are helpful in the medium to long term and risk taking the Cook Islands' economy into a downward spiral.

Restoring GDP to previous levels is expected to solve many problems for the Cook Islands' economy both for the private sector and for public debt. A key aspect of this is opening our borders to tourism which makes up 65 per cent of GDP directly and an estimated 85 per cent including indirect activity. The longer we are unable to welcome tourists safely into our country, the more at-risk our cash reserve position (and our debt position) is, so this is a crucial determinant of the path to recovery.

If it takes too long to recover GDP then the CIG will be forced to incur too much debt and risk the debt burden becoming too large or reducing government expenditure which will deepen the current recession. The subsequent impact on both the size of the private sector and the public sector is very likely to impact on Cook Islanders moving to NZ and/or Australia in search of work and higher incomes.

In the medium to long term a sustained reduction in either our work force or our population will be detrimental to our economy to the point of collapse. As work force drops this has a negative impact on supply side of our economy and if population falls this has a negative impact on the demand side. Both reduce GDP further and lead ultimately to a dangerous downward economic spiral.

The importance of recovery is why GDP growth through capital investment has been added as a fiscal rule in the updated Medium-Term Fiscal Strategy, as it is crucial to restoring our fiscal position.

We also note that $15 million within the ERR was set aside as contingency funding in case of a further border closure of up to 3 months. A sustained border closure of more than 3 months will fully deplete this contingency.

**2. Medium-Term Fiscal Framework (MTFF)**

As our previous fiscal anchor and fiscal rules are no longer appropriate for the current state of our economy after the economic impacts of the pandemic, a new Medium Term Fiscal Framework has been drafted with a new set of rules which are appropriate for the changed situation. The first of these is minimum cash availability (used as the fiscal anchor) to ensure Government can continue to pay its bills, and public servant' salaries and wages. Key to this management is the Cash Management Strategy below. The other fiscal rules relate largely to responsible government expenditure given the current recessionary environment and managing our resulting debt carefully and sustainably.

Shrinking Government expenditure is counterintuitive in a recession and lowers GDP even further, and would very likely lead to even greater levels of outward migration. Simultaneously we cannot allow Government expenditure to increase and remain fiscally responsible as well as limiting debt growth. The updated MTFS positions Government expenditure to maintain this balance.

**3. Borrowing**

There are two types of borrowing. Borrowing for stimulus and borrowing for fiscal deficits (government's costs exceed revenues).

Borrowing for stimulus is focused on stimulating GDP through investing in infrastructure. This can be healthy borrowing, since it allows for a growth in GDP while also providing well-targeted capital projects with long term pay back (i.e. long term additional income stream either directly or as an opportunity cost saving). The key with borrowing for infrastructure stimulus is that the capital provides benefit (e.g. an income stream or key social benefit) that is greater than the cost of borrowing.

The second form of borrowing is to cover the operating deficit. This is bad debt if it continues for more than the short-term (to smooth out temporary negative economic conditions) because it has been spent as part of usual operational spend and simply needs to be repaid in the future, without contributing to future GDP growth. The easiest way to repay this debt is through future economic growth since GDP growth provides tax growth.

To recognise the dramatically different environment around debt levels, the Net Debt Rule in the MTFF has been updated, with a soft cap of 55 per cent of GDP, and a hard cap of 65 per cent.

**4. Survival and/or long-term economic scarring**

There is a real risk that if some variables don't go our way over the next 6-12 months, then we may never recover our economy sufficiently to pay back long-term debt. If this situation occurs, the Government will be forced to take on unsustainable amounts of debt, and the debt repayments will consume an ever-growing proportion of expenditure, reducing the ability to achieve other priorities.

The key variables are population and work force. If these two variables continue to decline in Rarotonga (as they have for many years across the Pa Enua) then it will become very difficult to foresee a future without long term economic scarring.

We have 8 work streams under which there are 17 projects which make up the ERR. If we can get a 60% success rate from those projects, then we should see significant progress in regaining pre-covid levels of GDP.

Debt repayments are a significant issue. It is not the size of the debt but the ability of servicing that debt which is the major concern. There will be some more challenging repayments towards the end of this decade, and discussions with our creditors around refinancing will be important to ensure these remain affordable.

The other significant challenge is the wage/salary gap with NZ and Australia. Already many Cook Islanders choose to work in those economies because of the higher levels of remuneration. There are comparative advantages for young Cook Islanders to live and work in the Cook Island economy. We need to market those comparative advantages both to stem the outflow and encourage inflow.

## Tactical versus Strategic Response

The Economic Recovery Roadmap establishes a strategic response that may potentially extend beyond the current medium-term fiscal planning horizon, which the proposed MTFF will continue to complement. Both the ERR and the MTFS are designed to create a viable pathway through and beyond the economic impact of COVID-19 with a sustainable level of debt funding that supports the long-term prospects of the Cook Islands.

A tactical response that can bridge the current fiscal and economic circumstances and position the Cook Islands economy to respond to these strategic measures is necessary, and considers both further tactical borrowing and expenditure considerations. This is described in the next section.

# Cash Management 2021/22

MFEM continues to manage cashflow requirements against the level of general cash reserves and where necessary, put in place procedures to ensure liquidity risks are mitigated in the short term (FY22). The importance of cash management is reflected in the updated Medium-Term Fiscal Strategy, which uses cash reserves as the Fiscal Anchor.

To mitigate liquidity risks, the Crown's immediate priority is to secure alternative financing whilst minimising the impact on government spending, specifically spending that is necessary to support the people and the economy and its infrastructure spending to support GDP growth.

The main underlying target is to maintain a level of general cash reserves above $20 million, equivalent to 1 month of operation in the short term, noting the 3 months requirement within the MTFS in the medium-long term.

## 1. External Contingency financing

In addition to the existing ADB US$40 million loan, the Crown is also in discussion with ADB to establish a precautionary financing facility (contingency loan) of a further US$40 million that can be utilised if and when pre-defined triggers are met. The facility is expected to be available from December 2021 onward.

The precautionary finance option will become available for government to request disbursement when:

1. Cumulative monthly arrivals over the preceding 12 months (inclusive of the reference month) are more than 20% below the 3-year average over the 2016-19 period (inclusive); and
2. Operating cash balances accessible to government for meeting expenditure requirements and not legislatively protected, fall below $20 million.

Compared to budget FY22 forecasts, the visitor arrivals trigger will be met right through until the end of the 2022 calendar year, so only the cash balances trigger would be binding during this period.

## 2. Internal Contingency funds

The general cash reserves at the end of August 2021 were $50.8 million (up $7.6 million) compared to the forecast. This was mainly due to an additional $3.8 million received from the Financial Supervisory Commission (FSC) as part of vested asset liquidation, and in Capital projects due to scheduling requirements.

| **General Cash Reserves** | **Amount ('000)** |
|---|---|
| Total cash at bank | $88,827 |
| less: Commited Funds | |
| Loan Repayment Fund (LRF) | $20,956 |
| Infrastructure Trust Fund | $7,961 |
| Disaster Response Fund | $1,979 |
| Other Trust Funds | $3,560 |
| Total Committed Funds | $34,456 |

| | |
|---|---|
| Other Reserves Fund | |
| General Reserves - legacy | $3,544 |
| Total Other Reserves Fund | $3,544 |
| **Total General Cash Reserves** | **$50,827** |

The Crown has identified that it can, in addition to general cash reserves, and based on timing:

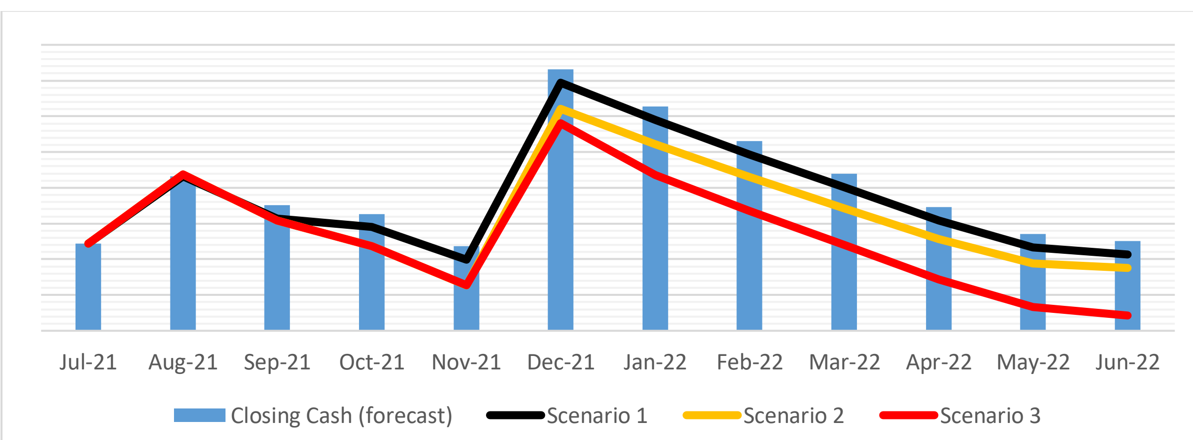
- drawdown on $3.5 million from general reserves.
  - General reserves were setup to receive 0.05% of tax take each year, this was later replaced by the establishment of the Stabilisation Fund/Policy.
- temporary drawdown on the LRF.
  - The requirement of the LRF Act is to ensure the balance of the fund <u>"is no less than the projected amount of government debt due to be paid in that financial year (the debt service requirements)"</u>
  - the annual debt servicing amount is $12.9 million, was transferred to LRF in July as a matter of policy.
  - This can be used in a worst-case scenario temporarily but would require back-filling within the fiscal year.

## 3. Responding to Scenarios

With the recent border closure, the Cash Management Committee (MFEM, ADB, MFAT) continues to play an important role in refining the modelling associated with the cash reserves.

The graph demonstrates the Crown's cash position (million) forecasted monthly for the FY22, including the funding provided by the Economic Recovery Program loan (ADB) to be drawn in December 2021.

**Figure 1.1 – Cashflow Forecast FY22**




Our internal assessment of the current situation has pointed to a potential 3-month border closure scenario (Scenario 2).

**Figure 1.2 – Cashflow projections applying scenario assumptions[1]**

| | Jul-21 | Aug-21 | Sep-21 | Oct-21 | Nov-21 | Dec-21 | Jan-22 | Feb-22 | Mar-22 | Apr-22 | May-22 | Jun-22 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Scenario 1 | $24,328 | $43,198 | $31,349 | $28,959 | $19,886 | $69,401 | $58,992 | $49,291 | $40,102 | $30,842 | $23,340 | $21,336 |
| Scenario 2 | $24,328 | $43,730 | $30,811 | $23,591 | $12,689 | $62,087 | $52,169 | $42,959 | $34,337 | $25,721 | $18,862 | $17,501 |
| Scenario 3 | $24,328 | $43,730 | $30,811 | $23,591 | $12,689 | $58,063 | $43,557 | $33,528 | $24,012 | $14,426 | $6,597 | $4,266 |

Scenario 1 has been assessed as low impact based on the assumed impact on the forecast with a residual general cash balance of $21.3 million – above the target.

## Responding to Scenario 2

Figure 1.2 demonstrated cash projections to fall below the target by November 2021, May and June 2022.

### Risk Assessment: Medium level impact

- Expenditure timing may partially or fully mitigate the shortfall during any period.
- The impact can be fully mitigated by the internal contingency fund that can be accessed in the first instance
- The risk is further mitigated by securing external contingency financing as a backup, timing will not be available until December 2021.

1. November 2021 – gap is $7.3 million
   - Actual general cash reserves were up $7.6 million at the end of August compared to forecast.
   - MFEM to pause bulk funding - review and identify budget items that can be paid on invoices.
   - MFEM to actively monitor spending from September – November 2021 by revising spending forecast related to Capital and Administered Payments.

2. May and June 2022 – gap is an accumulated $3.6 million
   - Drawdown on general reserves $3.5 million – refer to the section on internal contingency funds.

## Responding to Scenario 3

Figure 1.2 demonstrated cash projections for scenario 3 to fall below the target by November 2021 and from March to June 2022.

### Risk Assessment: High level impact

- Expenditure timing may partially mitigate the shortfall during any period.

[1] Refer to the section on the assumption

- The impact is mitigated to an extent by the internal contingency fund that can be accessed in the first instance.
- The impact is further mitigated by securing external contingency financing as a backup, timing will not be available until December 2021.
- Consider other alternative grant financing.

1. November 2021 – gap is $7.3 million
    - Actual general cash reserves were up $7.6 million at the end of August compared to forecast.
    - MFEM to pause bulk funding - review and identify budget items that can be paid on invoices.
    - MFEM to actively monitor spending from September – November 2021 by revising spending forecast related to Capital and Administered Payments.
    - MFEM to identify Capital projects that can be deferred. Cabinet support may be required).

2. April to June 2022 – gap is an accumulated $34.7 million
    - Drawdown on general reserves $3.5 million – refer to the section on internal contingency funds.
    - Drawdown on precautionary financing loan with ADB of $30 million
    - MFEM to pause bulk funding - review and identify budget items that can be paid on invoices.
    - MFEM to actively monitor spending by revising spending forecast related to Capital and Administered Payments.
    - MFEM to identify Capital projects that can be deferred. . (Cabinet support may be required).

## Scenario Assumptions:

The baseline scenario (Closing Cash) projections assume:

- Revenue estimates are received
- 100% spending of the appropriation
- ADB policy-based loan facility of US$40 million is drawn in December 2021

Scenario 1 – September border closed (1 month)

- Reduction in revenue $3.7m
- Increase in spending $5m is covered from ERR budget

Scenario 2 – September to November border closed (3 months)

- Reduction in revenue $7.6m
- Increase in spending of $15m is covered from ERR budget

Scenario 3 – September to January border closed (5 months)

- Reduction in revenue $10.8m
- Increase in spending total $25m - $15m covered from ERR, $10m additional financing

## Balancing the two strategies

Managing the cash reserves and adequately stimulating the economy may seem to conflict with each other – and while this can sometimes be true, it is important to manage these in union. To do this, there are three possible paths forward – Path A, Path B and Path C, in order of desirability. The Government is taking steps to prepare for each of these paths, so circumstance arises there is already thought and planning in place into how best to deal with the challenges posed.

**Path A** (Scenario 2)
Path A is a situation where any border closure in 2021/22 is kept below 3 months, and the impacts on the fiscal situation are manageable within the current envelope.
The current estimates around the border closure are that this is the path we are currently on, with existing contingencies being sufficient to cover the necessary business support measures as well as the reduction in revenue. This includes the budget support provided by the drawdown of the ADB loan for US$40 million (borrowed in New Zealand dollars).

**Path B** (Scenario 3 with Debt plus Grant Funding)
This situation is where any 2021/22 border closure extends past 3 months, especially if it exceeds 6 months with some grant financing provided by development partners to assist in closing the fiscal gap.

As discussed in above, a 5-month border closure is expected to require a minimum additional $10 million in expenditure, while revenues will be almost $11 million lower. This creates a total gap of $21 million in the 2021/22 fiscal year, pushing cash reserves well below the $20 million threshold – to an estimated low point of $4.3 million in June, after some measures have been taken to reprioritise spending. Prior to the drawdown of the loan from the ADB in December, cash reserves reach a low point of $12.7 million in November. This corresponds to Scenario 3 above.

For the gap at the end of the year to be addressed, this path requires additional financing – either in the form of drawing down the Precautionary Finance Option from the ADB (the additional US$40m), or in grant funding from development partners (or some combination). The draw down of the additional debt brings with it additional debt servicing obligations which must be taken into consideration as well (although the grace period does assist in this).

**Path C** (Scenario 3 with Debt Funding)
This is similar to Path B, however there is no grant financing provided by development partners. This is the most difficult path, with only the loan draw down available to finance the gap. This path will likely require cuts to Government expenditure which carries significant risk of

exacerbating the downturn and compromising any economic recovery in both the short and long term. These cuts would likely mean a phasing out of the business support measures and reductions in expenditure on other government projects and programmes to preserve the cash reserves, as well as a significant reduction in capital investment projects

The Survival and Cash Management Strategy discussed here is part of the reason that Cash Management is so crucial to the economic fortunes of the Cook Islands in the immediate term – as it determines the ability for the Government to spend and stimulate the economy from this low point. Working toward the goals set out in these strategies (and the MTFS alongside these) is key to maintaining good fiscal management in the Cook Islands. These key documents allow the Cook Islands Government to work with the assistance of development partners to chart a path forward in these challenging times.