



Mission Conclusions
2015 Macroeconomic Assessment of the Cook Islands
October 2015

I. CONTEXT

1. As a small island nation dispersed over a wide area of ocean, Cook Islands faces particular challenges related to lack of opportunities to achieve economies of scale and vulnerability to natural disasters and external shocks. The Cook Islands has one of the highest per capita incomes in the Pacific region, but free movement of its people to New Zealand has led to a declining population due to emigration.

II. OVERVIEW

2. **The mission¹ commends the government in sustaining macroeconomic stability in a period of low and volatile economic growth.** Cook Islands has adequate fiscal buffers for management of fiscal risks. The country's debt is well within the government's threshold of 35%. Prices have been relatively stable, goods and services trade has surpluses equivalent to about 30% of GDP and the financial system is relatively stable.

3. **The greatest challenge facing the country is to raise the long-term rate of economic growth.** Long-term average growth currently hovers close to zero. This manifests itself in low employment creation and slow growth in government revenue which can hamper the provision of essential services and the desired level of welfare payments. The major factor constraining growth is a lack of investment particularly by the private sector.

4. **The government will need to persist with the implementation of fundamental reforms to sustainably raise the level of private sector investment in the long term.** The needs for reforms are well understood. The mission fully appreciates the important concomitant social issues that are associated with many of these reforms and encourages government to seek solutions in an inclusive manner. The mission has identified several steps that the government can immediately take to facilitate investment and growth.

III. DEVELOPMENTS, OUTLOOK AND RISKS

5. **The Cook Islands economy has contracted with a slowdown in construction activity. Prices remain stable.** The economy has been declining over the last three years and is expected to continue to contract in the current fiscal year, albeit at a slower rate. Inflation over the last 3 years has averaged about 2½% and is expected to be stable at 2% in this fiscal year.

¹ The mission comprised Shiu Raj Singh (team leader), Savenaca Narube and Gina Williamson.

An improvement in the fuel price regulatory framework and stable global commodity prices have contributed to this stability.

6. The economy is expected to grow by about 1% on average over the medium term.

This growth is supported by a gradual increase in visitor arrivals as economic conditions in source markets improve and as the Cook Islands Tourism Corporation implements initiatives to attract more tourists during the off-peak season. The need to increase accommodation capacity and improve the quality of accommodation will create additional construction activity. Inflation is expected to remain between 2-3% as imported prices remain stable.

7. The expansionary stance in fiscal policy is broadly appropriate to stimulate growth.

The fiscal deficit averaged 2½% of GDP between 2009/10 and 2014/15 financed by debt. Gross public debt rose to almost 28% of GDP over this period. The primary balance, inclusive of operating grants, was in surplus. Despite a declining economy, tax revenue has remained buoyant due to improved administration and compliance. There is an apparent focus of tax administration on collection of taxes from individuals. The effective tax rate for individuals was above 6% in 2014/15, but was 3% for businesses. Expenditure levels remain high with a substantial increase in capital expenditure. Delays in the implementation of capital expenditure and the need to maintain reserves for debt service, disaster management and an appropriate level of working capital, have seen government deposits held in the banking system rise to 20¾% of GDP.

8. High tourism-related exports underpin the country's large current account surplus.

Government estimates and the mission's analysis suggest that the large current account surplus will continue. Imports of goods and services have moved in line with visitor arrivals. Goods exports have grown with growth concentrated in fisheries. The trade deficit in goods is offset by the large surplus on trade in services generated largely by tourism. The trend suggests a continuing current account surplus of above 30% of GDP.

9. The financial sector has ample liquidity and is stable.

Asset quality in the banking sector has significantly improved as non-performing loans have declined to around 7% from a high of 16%. The liquid liabilities of commercial bank are more than 13% higher than net domestic credit. With high liquidity, the sluggish growth in private sector credit in part reflects a conservative approach to lending by commercial banks at present as they attempt to reduce non-performing loans and improve the overall quality of their lending portfolios. The Cook Islands National Superannuation Fund has accumulated domestic savings, which are appropriately invested offshore.

10. Major risks to the economic outlook are natural disasters and a slowdown in the economies of major trading partners.

The Cook Islands is vulnerable to natural disasters, specifically cyclones and tsunamis. The government has put in place several measures to reduce the financial impact of natural disasters on the budget including catastrophe insurance and disaster management reserves. Being an open economy, the country is also vulnerable to risks of slowing growth in the economies of major trading partners, particularly New Zealand and Australia. Fiscal risks arising from contingent liabilities of state owned enterprises (SOEs) are low at present but Government will need to continue with improvements in the governance and the monitoring of SOEs financial performance and position.

IV. FISCAL SUSTAINABILITY

11. **Given the outlook for low growth, the mission is of the view that fiscal policy can be countercyclical but on the proviso that new programs promote growth, be fiscally sustainable and are appropriately scrutinized.** Given the makeup of the economy and the adoption of the New Zealand dollar as its currency, fiscal policy is the main lever for growth and development in the Cook Islands. The mission therefore supports the government's expansionary budget for 2015/16, and medium-term projections to 2016/17. The government has accumulated fiscal buffers, which allow it to implement currently planned capital projects that generate economic returns. However, the mission urges constraint on fiscal expansion to ensure that fiscal stability is maintained.

12. **To help government maintain fiscal stability, it should continue to track and benchmark financial ratios, particularly the debt target.** The government has a set of ratios to guide its fiscal stance. These include debt, personnel costs, revenue and deficits. These ratios help the government fulfill the provisions of the MFEM Act. Given the vulnerabilities the Cook Islands faces, the government has appropriately set its long-term public debt threshold at 35% of GDP. Deviations from the benchmarks are inevitable from time to time, but when they occur measures should be put in place to ensure ratios return to within thresholds. The contingent liabilities of the government at the end of 2014/15 fiscal year were equivalent to a little over 2% of GDP. This does not include implicit guarantees to the government owned commercial bank and the superannuation fund. Government should take these contingency liabilities into account in its risk management strategy.

V. FINANCIAL STABILITY

13. **Improvements in supervision of the financial system need to be maintained.** Supervisory functions for the onshore and offshore institutions by the Financial Supervisory Commission (FSC) have been strengthened and appear adequate. The capacity for offsite supervision of financial institutions has increased with a sufficient range of financial data being collected on a regular basis. A logical extension of strengthening the financial system is the supervision of the Cook Islands National Superannuation Fund by the FSC.

14. **There are options to further develop the financial sector and reduce cost of financial services.** Cook Islands have a high level of financial inclusion and lower interest margins than most other Pacific Island countries. Nevertheless, the cost of financial services is high, particularly for small and medium-sized enterprises. While the cautious lending behaviour of commercial banks is an understandable response to the high level of non-performing loans in the recent past, efforts should be made to address the low rate of growth in private sector credit. The absence of a credit bureau or a registry for movable collateral may affect financial deepening in the country. Government is urged to continue to implement the relevant recommendations of the Banking Review.

VI. IMPROVING GROWTH PROSPECTS

15. **To raise economic growth from its current low level, the Government will need to persist in implementing fundamental reforms.** These reforms include public sector and

public financial management, land leasing, labour market and immigration. While the need for many of these reforms has been accepted and some of them are ongoing, government needs to strengthen the rate of their implementation subject to available resources and capacity. The country's development strategy emphasizes macroeconomic stability, developing agriculture and tourism industries, revitalizing exports and providing an enabling environment for business.

16. Public sector and public financial management reforms have progressed reasonably well over recent years. The 2015 Public Financial Management Performance Report has reflected the areas of recent improvements in and current strengths of the public financial management framework, and identified the remaining challenges. The mission recommends prioritization of actions to address remaining challenges in order to embed and build on progress made.

17. The government needs to consider ways of improving the economic potential in customary owned lands. Structural impediments to investment in large part relate to processes and structures related to the land tenure system. The mission appreciates the sensitivity and the complexity of land tenure reforms and recognizes that social and cultural issues need to be taken into account. However, this reform is central to promoting much needed investment. As a way forward, the government should consider establishing an advisory committee to facilitate improvements to land leasing within the local context. In the short term, government could increase the frequency of the sitting of the Lands Tribunal to reduce processing times on leasing transactions.

18. Policies need to allow for sufficient labour to meet business demand. Businesses' demand for labour outstrips local supply, indicating some need for foreign labour to support growth in output. Immigration legislation and policies need to be updated and processes clarified to ease access to foreign labour. There has been progress on employment relations regulation, including introducing dispute resolution frameworks. Further progress is necessary and this must balance the rights and interests of both employees and employers. Membership of the International Labour Organisation is indicative of recent and intended progress in this sphere.

19. Welfare payments should be targeted at those that need support and equity between payment groups should be promoted, While extreme poverty is absent in Cook Islands, there are challenges related to basic-needs poverty, and non-communicable diseases. The Cook Islands maintains a generous welfare payment system aimed at addressing the needs of the vulnerable members of society, which supplements government supported health and education services. Reforms in the welfare system must ensure that support reaches those that are vulnerable, improves the equity between different payment groups and ensures that the impact of the system on the budget resources can be sustained.

20. While there have been significant improvements in the quality of economic statistics, efforts to strengthen the collection and compilation of statistics needs to continue. Economic statistics form the cornerstone of economic decision making. Effective decision making is only possible if timely, comparable and verifiable statistics is available for a reasonable level of analysis of the costs and benefits of options for good decision making.