


Economic Planning Division

Cook Islands Economic Bulletin

November 2021

Highlights

- **The Cook Islands economy is still expected to recover strongly in the second half of 2021/22** – after the large fall in 2020/21 where GDP was estimated to contract by 23.2 per cent, the economy is forecast to grow by 12.3 per cent in 2021/22, on the back of around 6 months of quarantine-free travel. This growth is expected to continue in 2022/23 at similar rate of 13.6 per cent. Thereafter, growth is expected to moderate to 9.0 per cent in 2023/24, then 4.1 per cent in 2024/25. This outlook reflects the updated outlook for visitor arrivals, updates to the fiscal outlook and a significant methodological change in forecasting.

- **Inflation pressures rise** – growth of 2.2 per cent on average in 2020/21, and expected to rise further to 3.3 per cent in 2021/22 and 4.0 per cent in 2022/23 on the back of expected increases in capacity constraints such as labour and skills shortages, as well as global price growth, resulting in inflationary pressure.

- **Return of visitors is key** – Assumptions of border opening in January 2022, with an arrival profile similar to the previous opening in May 2021. Arrivals reach the 2018/19 level by 2024/25.

- **Government stimulus expected to wind down –** government stimulus has been the key driver of the economy through the pandemic, with the Economic Response Plan and Economic Recovery Roadmap providing a lot of support. As the rest of the economy recovers, this stimulus will need to be wound down, as debt servicing obligations increase and the need for support is removed.

- **Government debt has grown, but expected to fall to 22.0 per cent of GDP over forward years –** over the pandemic, the Cook Islands Government has taken on a significant amount of debt to provide support to the economy. This has caused the net debt position to change considerably from 2018/19, however the net debt position remains manageable and within fiscal rules. With this improvement in forecasts, net debt is expected to reduce to 22.0 per cent of GDP by 2025/26 – due to both higher GDP and debt balances beginning to be paid down.

MINISTRY OF **FINANCE AND ECONOMIC MANAGEMENT**
Government of the Cook Islands

Economy – Cook Islands

GDP outlook – welcome recovery post-pandemic

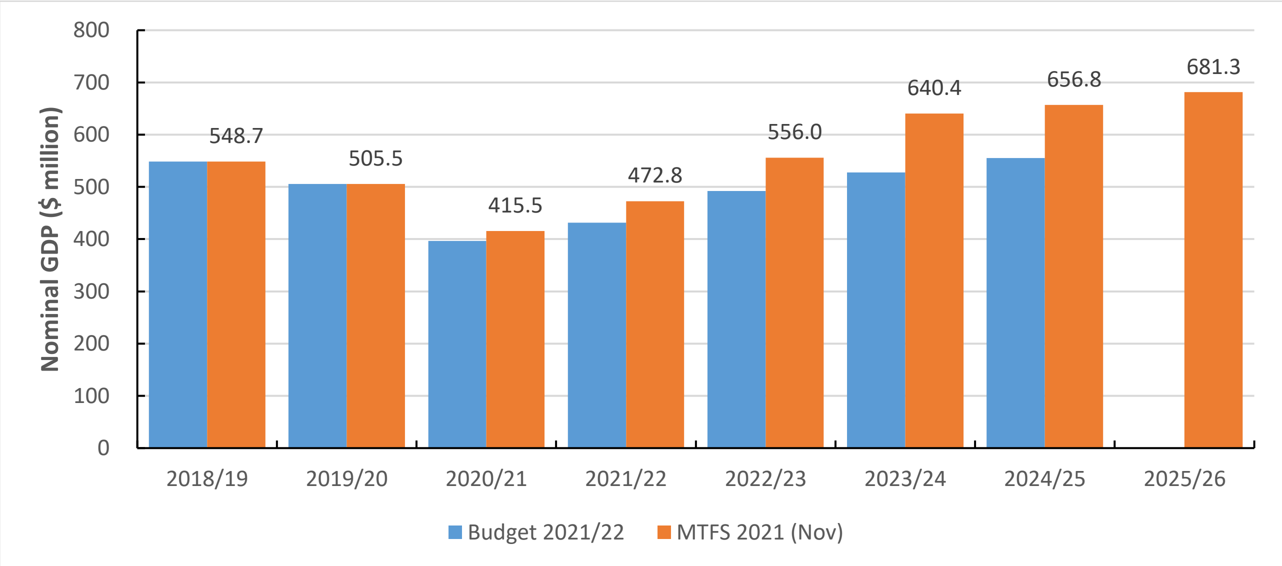
Forecast Nominal GDP is now considerably stronger than estimated in the 2021/22 Budget. This is largely a consequence of the new modelling approach, which captures the flow-through of growth to inflation and of savings to investment.

The change also has other contributors: for example the recovery is expected to be more rapid than expected in the 2021/22 Budget because of the higher-than-expected arrivals between May and August 2021 while the bubble was in operation.

As supply of inputs (especially labour) is constrained in the recovery period, price growth accelerates over 2022/23 and 2023/24. In other words, there is higher inflation.

Nominal GDP is expected to grow by 14.6 per cent in 2021/22, with over 40,000 visitors expected in five months from February 2022. This growth is then built upon with a further 17.6 per cent in 2022/23 as visitors exceed 100,000 for the first time since 2019/20, before moderating further. Due in part to higher inflation, nominal GDP is expected to reach pre-Covid levels by 2022/23.

Figure 1: Nominal GDP forecast comparisons – Budget versus MTFS (October 2021)



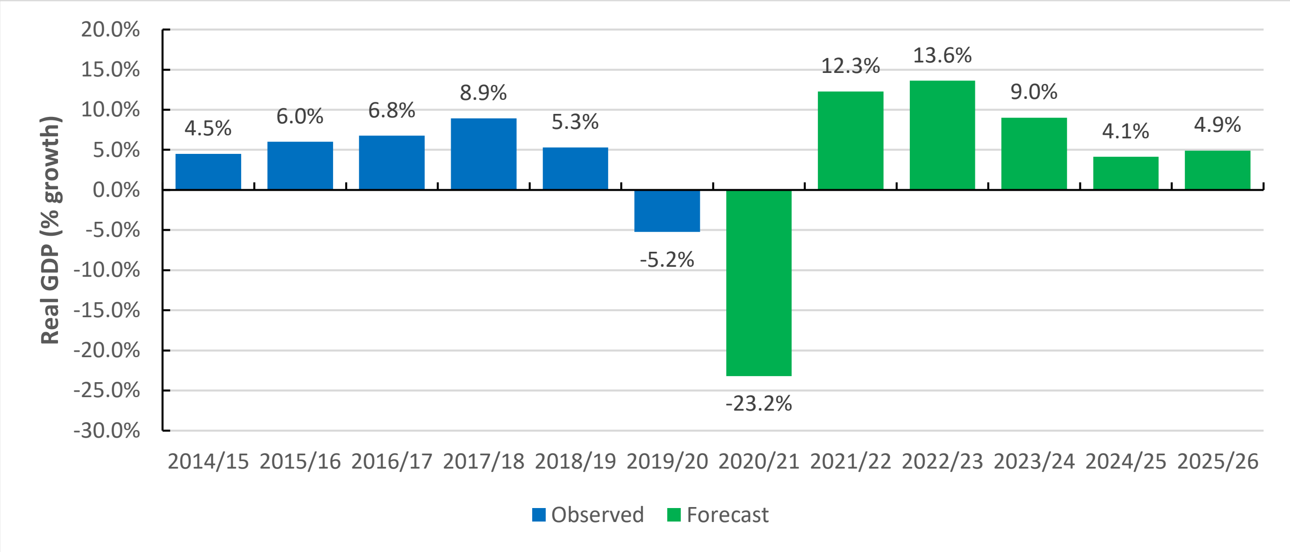
Source: Cook Islands Statistics Office, National Accounts, June Quarter 2021; MFEM estimates.

The forecast for real GDP growth is of 12.3 per cent in 2021/22 (from a very low base) and 13.6 per cent in 2022/23 (the first year without border closures). After these high-growth years, growth moderates to 9.0 per cent in 2023/24, 4.1 per cent in 2024/25 and 3.5 per cent in 2025/26. Real GDP is expected to reach pre-Covid levels by 2024/25.

The impact of the improvement to the modelling is shown in Figure 1 above.

Real GDP still shows a more gradual recovery than nominal GDP (as the impact of inflation is stripped away), with the profile largely following the return of visitors. Partially offsetting this is the slow removal of government stimulus from the high points of 2020/21 and 2021/22.

Figure 2: Real GDP Growth (percentage change, year on year)



Source: Cook Islands Statistics Office, National Accounts, June Quarter 2021; MFEM estimates.

Table 1 shows that real GDP growth is forecast to run higher than we expected in the 2021/22 Budget in June 2021. This is in part because we now expect investment to be more sustained than we did under the old modelling approach. This is due to the model which now more appropriately reflects high savings rates and the return of capital assets to productive use after much of the past two years not being utilised. The assumption is that higher savings leads to higher investment in the economy, through the bank lending and other investing, as higher profit margins return with the recovery in tourism. This effect is sufficiently strong to counteract the effect of lower visitor arrivals.

Table 1: Real GDP Growth (percentage change, year on year)

Real GDP Growth (%)	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**
Budget 2021/22 (Jun 2021)	-22.9%	6.9%	11.8%	5.0%	2.4%	
MTFS 2021 (Oct 2021)	-23.2%	12.3%	13.6%	9.0%	4.1%	3.5%

Change in methodology

MFEM have developed a computable general equilibrium model of the Cook Islands economy. The model was developed with assistance from an ADB technical advisor. A computable general equilibrium model (or 'CGE model') uses relationships in the economy to show how movements in one area lead to changes in another.

This is a more robust approach to forecasting, and modelling in general than the approach previously used, which utilized ARIMA modelling to use past data to project forwards – and as such was very reliant on a stable time series. The Covid-19 Pandemic made it quite clear that this approach was unsuited to the large structural break in the data, necessitating a change in approach. From the onset of the pandemic, attempts were made to adjust the ARIMA-based modelling, however this is not as strong as utilizing a general equilibrium approach.

The change in methodology has led to a different outlook – one that shows a faster recovery from the recession than was previously forecast.

What has changed? The CGE modelling now more accurately captures:

- Private savings and investment (as well as government savings and investment)

- Factor price movements
- Exchange rate movements
- Varied impacts of different government expenditure (government consumption versus transfers)
- Household consumption
- Capital utilization

Bringing capital out of mothballs

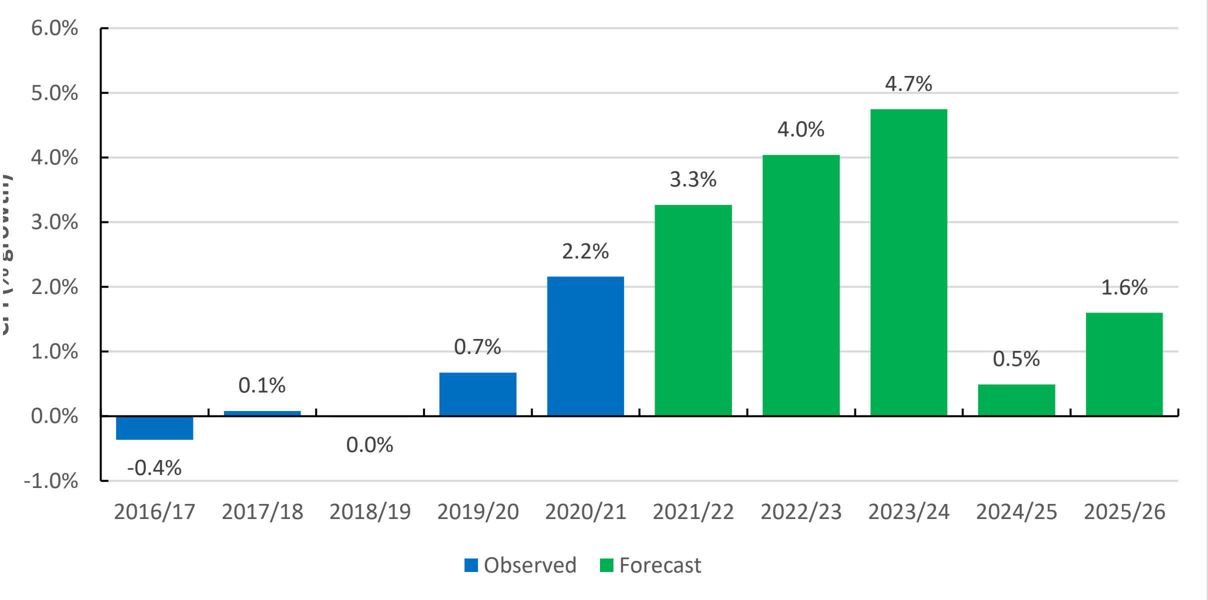
One key factor in the faster-than expected recovery from the pandemic is that capital that has been unproductive while tourists have been unable to visit the Cook Islands is able to come back into use. This 'injection' of previously dormant capital (largely in the accommodation sector) is driving a significant portion of the upward revision in forecasts.

On top of this, better accounting for savings and investment flows through the profitability of businesses allows for a more consistent forecasting approach. The general equilibrium approach means that it can now be modelled that when visitors return to the Cook Islands and businesses begin to see profits again these profits must then go somewhere – either to be reinvested in the Cook Islands (either directly by the business, or via an intermediary such as a bank), or transferred out of the country (by either of the same mechanism). How the proportion of profit that is retained in the Cook Islands is then spent, has a large impact on overall economic activity – as it impacts the level of investment, imports and prices.

Inflation –expected to rise as supply-side constraints bite, while demand recovers

The Consumer Price Index (CPI) growth for 2020/21 averaged 2.2 per cent over the year, compared to quite low inflation in recent years (Chart 5). Inflation is forecast to pick up to 3.3 per cent in 2021/22 before rising further to about 4.7 per cent in 2023/24, before moderating over the forecast period, on the back of expected increases in capacity constraints such as labour and skills shortages, with demand also growing from the low levels of the pandemic as well as pressure from rising global prices.

Chart 5: CPI (average annual percentage change)



Source: Cook Islands Statistics Office, Consumer Price Index, June Quarter 2021; MFEM estimates.

GDP Deflator

The GDP Deflator is broadly similar to the profile of CPI, with the strongest growth in 2022/23 and 2023/24, after seeing weak price growth through the deepest points of the recession, while labour constraints mean price growth strengthens through the recovery.

Table 2: GDP Deflator (percentage change, year on year)

GDF Deflator (% change)	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
Budget 2021/22 (Jun 2021)	1.7%	1.8%	2.0%	2.2%	2.7%	
MTFS 2021 (Oct 2021)	0.5%	2.0%	3.5%	5.6%	-1.5%	1.3%

Economy – International

As a small, open and tourism-reliant economy the Cook Islands' economic fortunes are heavily tied to those of the source markets for tourists – New Zealand and Australia in particular. This has never been clearer than through the Covid-19 pandemic, where despite not having a single case of the virus, the Cook Islands' economy has been one of the most heavily impacted in the world.

New Zealand – inflationary pressures mean all eyes on the RBNZ

Prior to the current outbreak of coronavirus in New Zealand, the economic recovery had been stronger than expected – having returned to pre-Covid levels of activity. This has led to more pressures in the economy than anticipated, with the Reserve Bank of New Zealand (RBNZ) having raised interest rates in October, citing a desire to reduce "the level of monetary stimulus so as to maintain low inflation and support maximum sustainable employment." Growing cost pressures are becoming more persistent through capacity constraints –through the labour market in particular.

The RBNZ are expecting headline CPI to increase above 4 per cent in the short term, so further rate rises are on the horizon as well, further removing the monetary policy stimulus. These moves will be conditional on the inflation and employment situation developing as restrictions are slowly eased.

The RBNZ *Monetary Policy Statement* August *2021* forecasts annual GDP growth of 5.2 per cent in the 2021/22 year, before lowering to 2.3 per cent the following year. These forecasts are unlikely to be realized now, with the ongoing restrictions in Auckland. This does provide some context for the propensity for the New Zealand economy to bounce back once the current situation changes.

New Zealand inflation

As our largest trading partner, movements in inflation in New Zealand have impacts on the price level in the Cook Islands. With price pressure rising in New Zealand as a result of both domestic economic pressures as well as global price rises, inflation is expected to rise in the Cook Islands after many years of slow or no price growth.

Australia – post-lockdown recovery anticipated

In October 2021, the Reserve Bank of Australia (RBA) kept its cash rate at the emergency low level of 0.1 per cent, and continued asset purchases to hold bond prices lower. The RBA cited the delta outbreak and the associated restrictions as the key reason for the recovery stalling – but there remains considerable uncertainty.

Recovery in the Australian economy is expected to be slower than before the delta strain, with GDP expected to be back to its pre-delta path by the second half of 2022. Inflationary pressures remain subdued, however the RBA does mention some concerns around house price growth in particular as housing credit growth has been very rapid.

Global — IMF concerns around diverging recoveries

The International Monetary Fund (IMF) in its October 2021 W*orld Economic Outlook* warns of the recovery from Covid-19 diverging along lines determined by vaccine access and early policy support. This has resulted in a slight downgrade in expected growth in the global economy of 5.9 per cent in 2021 and 4.9 per cent in 2022 (0.1 percentage points lower than the June 2021 report).

Over the medium-term, the IMF expects a greater share of global growth to be driven by advanced economies, led by the United States with further policy support. In contrast, emerging market economies are expected to see persistent output losses, as are developing economies.

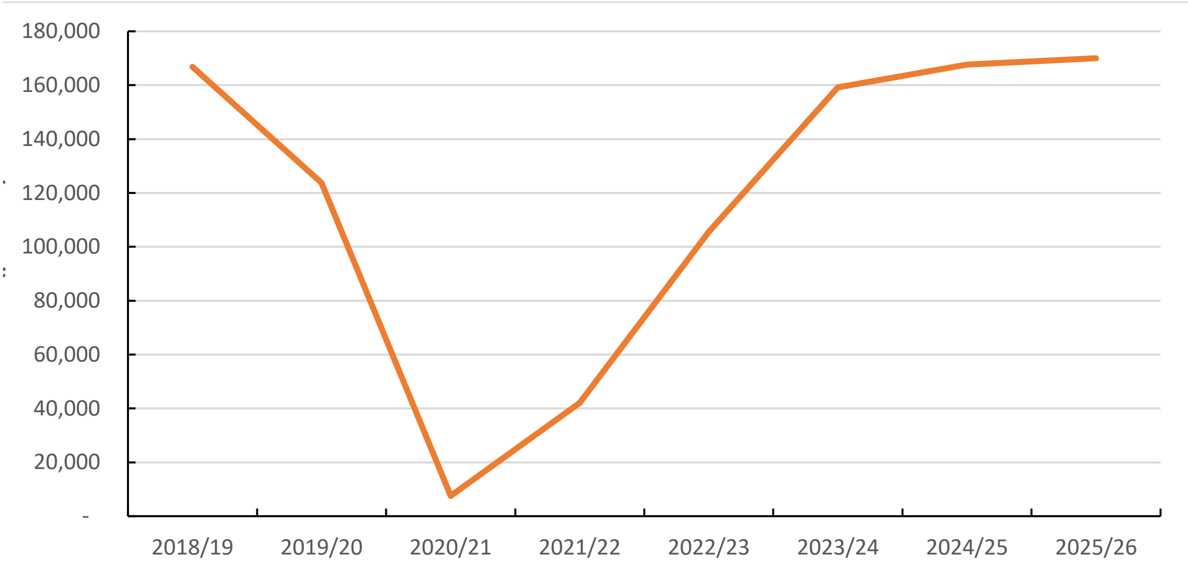
Arrivals

The forecast profile is based on the assumption of the border to New Zealand visitors opening in January 2022, with travel from Australia being available from June 2022, and other markets to follow. The return to 'full' visitor arrivals is expected to follow a similar profile to the opening between May and August, returning to expected full shares in 2024/25.

Table 3: Visitor arrivals, by year

Arrivals (no.persons)	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**
Budget 2021/22 (Jun 2021)	5,156	98,527	154,184	170,014	175,927	
MTFS 2021 (Oct 2021)	7,538	42,089	105,642	159,246	167,591	170,007

Chart 12: Visitor arrivals forecasts, annual



Source: MFEM estimates.

Risks to the outlook

Clearly the current environment is very uncertain for both the Cook Islands and the global economy as the world begins to come out of the Covid-19 pandemic. This uncertainty is greatest in movements to allow tourists into the Cook Islands, and the restrictions which will be in place to safely allow this. Some key risks to the economic outlook are outlined here:

- **Slower return of tourists** – if tourists are more cautious to return to the Cook Islands than they were between May and August 2021, this will slow the pace of recovery significantly. Preparation for this possibility is being undertaken by modelling a range of different tourism-recovery scenarios.
- **Further mutations of Covid-19** – if further mutations or strains of the virus occur, reducing the efficacy of vaccines then it is possible restrictions may be needed. This would have a large negative impact on the economic recovery.
- **Forced reduction in government spending** – if an unforeseen shock occurred and development partners and financiers were unwilling to provide finance to the Cook Islands Government, this may necessitate a sharp reduction in government expenditure, which would therefore reduce the amount of activity in the economy.
- **Issues in the New Zealand recovery** – as our largest trading partner, the New Zealand economy is important for what occurs in the Cook Islands economy, and if the recovery in New Zealand stalls or falters, this may reduce the potential number of visitors looking to travel to the Cook Islands.

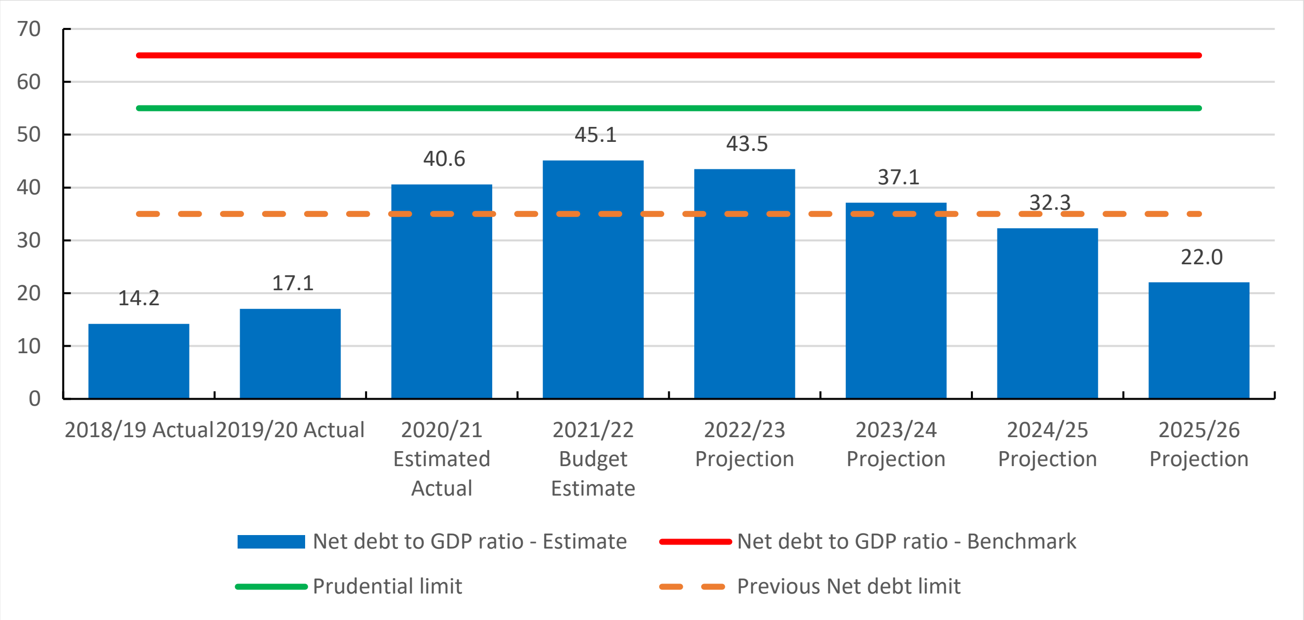
Technical risk

As this is the first round utilising a new modelling framework, there are inherent risks to the accuracy of the forecasts. While the model has been tested using historical data (and the framework is a more robust one), the accuracy of the outputs will not be known until future outcomes are available to compare to.

Government debt

Throughout the COVID-19 pandemic, the Cook Islands Government has taken on a substantial amount of debt to provide stimulus and support to the economy. Fortunately, prior to March 2020, the Cook Islands had a very low level of net debt (14.2% of GDP in 2018/19)[1] with an additional $56.7 million in the Stabilisation Fund as well.

Figure 3: Net Debt to GDP (2018/19 to 2025/26)



Source: MFEM estimates.

[1] The Cook Islands commonly reports on 'Debt Net of the Loan Repayment Fund' as Net Debt, which is a more conservative measure of Net Debt than is commonly used internationally. International reporting considers accounts such as the Stabilisation Fund as well and under this definition the 2018/19 level of Net Debt would be equal to 3.9% of GDP.

This low level of existing debt has enabled the increase in debt to be manageable through a difficult time, and while this larger stock does increase the burden on Government, it is a manageable burden at current levels. To reflect this, Government recently approved the *Medium-term Fiscal Framework* which included a new set of fiscal rules that are more appropriate to the current circumstances.

These new rules show that there is still room available for the government to take on additional debt if needed – however any new debt should be considered in conjunction with the impact on debt servicing and cash balances. Debt servicing is expected to become a larger concern over the medium-term as grace periods on new debt end and principal repayments begin.

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