TE TANGO AKATEREANGA MONI O TE IPUKAREA
MINISTRY OF FINANCE & ECONOMIC MANAGEMENT
GOVERNMENT OF THE COOK ISLANDS

Cook Islands Medium-Term Debt Management Strategy 2022-2026

June 2022

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Abbreviations

ADB	Asian Development Bank
AIIB	Asian Infrastructure Investment Bank
ATM	Average Time to Maturity
ATR	Average Time to Refixing
BKBM	Bank Bill Benchmark Rate
CPI	Consumer Price Index
DMS	Debt Management Strategy
DSA	Debt Sustainability Analysis
ERP	Economic Response Plan
ERR	Economic Recovery Roadmap
EXIM	Export-Import Bank of China
FRR	Fiscal Responsibility Ratios
FX	Foreign Exchange
FY	Financial Year
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IMF	International Monetary Fund
LIBOR	London Interbank Offer Rate
LRF	Loan Repayment Fund
LRF Act	Cook Islands Loan Repayment Fund Act 2014
MFEM	Ministry of Finance and Economic Management
MFEM Act	Ministry of Finance and Economic Management Act 1995-96
MTDS	Medium Term Debt Management Strategy
MTFS	Medium-Term Fiscal Strategy
NZD	New Zealand Dollar
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
PFTAC	Pacific Financial Technical Assistance Centre
PV	Present Value
RMB	Chinese Reminbi
S&P	Standard & Poor’s
SDR	Special Drawing Rights
SOE	State Own Enterprise
T-bills	Treasury bills
USD	United States Dollar
WB	World Bank

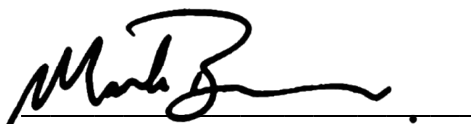
Foreword

Policymakers in the Cook Islands Government (CIG) face some particularly significant challenges in dealing with the recovery of our economy from the impacts of COVID-19 on the world. As one of the most severely impacted economies in the world, the extensive support and stimulus packages through the Economic Response Plan (ERP) and Economic Recovery Roadmap (ERR) have necessitated a marked increase in the level of debt held by the Cook Islands. This increased level of debt heightens the importance of effective debt management, to ensure our resources are well-directed and the Cook Islands people as well as creditors and development partners can have confidence in our debt situation.

The CIG is pleased to release this Medium-Term Debt Management Strategy (MTDS) as the guiding document around which the Cook Islands debt portfolio is managed. The MTDS is a framework to guide the debt management decisions and operations of the government, through aligning any new debt to portfolio-wide goals and targets, utilising natural foreign exchange hedges and formalising some of the management practices that have been informally used for some time. The MTDS is a key tool in ensuring the CIG will meet its debt management objectives, which are to meet the financing needs of the Crown at the lowest possible cost and a prudent level of risk, and to explore alternative financing sources to build resiliency.

The MTDS takes steps to mitigate some financing risks faced by the Cook Islands. Currently, a large majority of our debt is held by the Asian Development Bank (ADB), which has been a long-term close development partner of the Cook Islands. The MTDS opens up discussion around other creditors to reduce this reliance. One component of this is to investigate the potential for the CIG to issue securities in the New Zealand market, to determine if this is a viable option in the future.

I would like to thank our development partners for their assistance through this period, in particular the assistance provided by IMF-PFTAC in developing the MTDS. Together with partners such as New Zealand and the ADB, they will continue to play a key role in assisting us in implementing the strategy over the coming years.



Hon. Mark Brown
Prime Minister and Minister for Finance

Executive Summary

The Medium-Term Debt Management Strategy (MTDS) describes the policy the CIG plans to implement in managing its debt portfolio during the financial years 2023 - 2026.

The assessment of the cost and risk profile on the debt portfolio has identified that the main risks for the Cook Islands are interest rate risks and refinancing risks. The strategic targets listed as part of this MTDS are therefore focused on two main strategies:

I. to prescribe government's preferred options when taking on new debt to debt instruments that are with fixed interest rate, and
II. to improve the average time to maturity (ATM) of the debt portfolio by exploring refinancing options specifically for the post pandemic loans.

A secondary objective of this MTDS is to build resiliency by exploring alternative sources of financing to provide an opportunity to shape the Cook Islands public debt portfolio, in relation to cost and risk, as selection of debt financing instruments becomes broader.

The total value of public debt to the end of June 2022 is estimated at $228.3 million or 46.9% of GDP, an increase of $114 million (up 23%) from pre-pandemic levels. This increase has been primarily to support government's response to the economic impact of the pandemic. The government also revised its MTFS within this context to ensure the immediate needs of the Cook Islands are met while still adhering to fiscal sustainability over the medium-term.

The annual debt servicing on the additional debt is expected to double by 2024/25 when the post pandemic loans become due, which poses a refinancing risk for the government in the medium-term (should the government need to rollover the debt). The terms of the post pandemic loans were all within 10 years repayment tenure and the MTDS aim to guide the mitigation strategies the government could pursue to smooth out its debt repayment profile.

Another risk factor within the Cook Islands debt portfolio is the lack of diversification of lenders, the pandemic-related debt was made available to the Cook Islands from two lenders only, ADB and the AIIB. The financing lifeline provided by the ADB and the AIIB assisted government through the pandemic, but as the government focuses on recovery, exploring partnerships with other bilateral and multilateral institutions could provide broader financing options and mitigate the risk of reductions in existing lending programs and limited loan term selection.

Furthermore, the Cook Islands does not have a domestic debt market due to its size. However, issuing Government securities in New Zealand could be an interesting alternative to allow for further diversification of funding sources while minimising foreign currency risk. It is envisaged that a research paper will be produced on the feasibility of establishing such an alternative financing option during the term of the MTDS.

Effective implementation of the MTDS is crucial to keep the Cook Island's debt at a sustainable level. Accordingly, the government through the MFEM will report on the status of MTDS implementation against the set strategic targets annually through the budget process which includes reporting to Cabinet and tabling with Parliament.

1. Introduction

The Cook Islands has followed a conservative borrowing policy. The Cook Islands has maximised concessional flows when borrowing has been necessary. Where possible, grants from development partners have been prioritised over debt. The debt portfolio has been contracted mostly from multilateral and bilateral institutions on concessional terms. Prior to 2010, loans were contracted with long maturities and low, fixed interest rates. After 2010, loan duration shortened, with loans dominated in domestic currency on floating interest rate terms. This reflects a change of lending terms mainly on the part of the Asian Development Bank, the Cook Islands' primary creditor.

The pandemic has resulted in a fall of Cook Islands' GDP by over 22%. To respond to the shock of COVID-19, government developed and released the Economic Response Plan (ERP) with targeted intervention support packages and stimulus measures. The 2021/22 appropriation included an additional $33.5 million towards this initiative as well as economic recovery taking the overall ERP related budget since the pandemic to $129.5 million.

The Cook Islands continues to face challenges in accessing grants and concessional financing because of graduation from ODA and the ADB's classification of the Cook Islands as a high-income country, eligible only for OCR debt. The government believes that these classifications are now obsolete due to the size of the drop-in economic activity caused by the pandemic. Not only is the Cook Islands a Small Island Developing State (SIDS), but also a Micro-State with a population of less than 20,000. As a Small Island Micro-State existing challenges are exacerbated by the Cook Islands' inability to mount strong fiscal responses on its own.

The previous Cook Islands Debt Management Strategy was implicit and articulated through a set of rules and guiding principles. Although a formal debt management strategy is not required by legislation, debt management is encompassed in the principals of responsible fiscal management specified in the MFEM Act and the Loan Repayment Fund (LRF) Act implemented through the MTFF. The major rules and guidelines for debt management include:

- **Net Debt Rule**[1] – net debt should not exceed a soft cap of 55% of GDP and cannot exceed a hard cap of 65% of GDP.

- **Debt Sustainability** – Prior to undertaking debt on behalf of the Crown, MFEM must provide a debt sustainability assessment of the overall government debt, taking into account the proposed new debt, in accordance with the LRF Act.

- **Foreign Exchange Risk Mitigation** – the government strategy for mitigating exposure to exchange rate risk are:

  - Take new loans in the local currency (NZD)
  - Hold United States Dollar (USD) receipts in USD denominated bank accounts in the LRF. This is used for direct debt repayments in USD.

[1] Net Debt is 'Gross Debt net of the LRF' which is a more conservative measure of Net Debt than is commonly used internationally.

- **Loan Repayment Fund** – At the start of each financial year, sufficient funds must be allocated to the LRF to ensure that the balance of the fund is no less than the projected debt servicing requirements in that financial year, in accordance with the LRF Act.

- **Net Debt Servicing to Total Revenue** – The net debt servicing to total revenue should not exceed a soft cap of 10% and a hard cap of 15%.

This document formalises government's debt management strategy (MTDS) in the medium term to guide public debt management. This MTDS will be effective for 4 years, from 1 July 2022 to 30 June 2026. It provides guidance for government borrowing and sets benchmarks to manage public debt. These benchmarks will be monitored and evaluated annually against government performance in implementing the MTDS.

The MTDS is the outcome of a cost-risk analysis performed by the MFEM with the support of the IMF. The analysis used to inform the MTDS follows the guidance of the MTDS Analytical Tool and framework developed by the IMF and the World Bank. The analysis examined the costs and risks of the existing debt portfolio and those that could arise from the implementation of the MTDS over the four-year time horizon considering factors such as the macroeconomic and financial market environment, the availability of financing from creditors and vulnerabilities that may impact future borrowing requirements.

The MTDS sets out strategic targets to manage exposure to market risks. To achieve the optimal composition of the debt portfolio, the government will manage market risks associated with the public debt portfolio, specifically interest rate risk, refinancing risk and exchange rate risk.

2. Objectives and Scope

Objectives

The primary objective of the MTDS is to guide government in meeting the financing needs of the Crown at the lowest cost possible and a prudent level of risk. The MTDS provides government guidance by setting debt management targets that will contribute to maintaining prudent levels of debt and risks consistent with the Medium-Term Fiscal Framework (MTFF).

The secondary objective is to explore alternative financing sources to build resiliency. Diversification of development partners will provide further financing options for the Cook Islands when grant funding has been exhausted. This provides an opportunity to shape the debt portfolio, in relation to cost and risk, as selection of debt financing instruments becomes broader.

Scope

The MTDS covers Crown debt from both domestic and external lenders as defined by the Loan Repayment Fund (LRF) Act. Section 3 of the LRF Act defines government debt to include debt owed by Central government, State Owned Enterprises (SOEs) and any amounts for which government is liable as guarantor in accordance with any agreement.

Costs and Risks to be managed

The Cook Islands debt portfolio is subject to a range of costs and risks. The MTDS analysis has identified that the cost of debt would be minimised, and risk of debt distress kept at tolerable levels through limiting borrowing to debt which is semi-concessional - from both multilateral and bilateral funding agencies. The analysis also highlighted the need to explore the domestic-currency debt market to diversify funding sources and develop a domestic-currency investor base.

The main risks that the MTDS is designed to manage are:

- **Interest rate risk** – risk related to loans which are contracted with variable interest rate, where changes in the market environment can adversely impact the cost of those loans. To manage interest rate risk, concessional external borrowings at fixed and low interest rates would be prioritised. Interest rate risk is the main debt portfolio risk for the Cook Islands, particularly as the rates begin to move from historic lows towards more 'normal' settings.

- **Exchange rate or foreign currency risk** – risk arises when debt is held in foreign currency, and adverse movements in the exchange rate against the NZD will lead to increase costs. To minimize foreign currency risk, the government will constrain new borrowings to the local currency where possible and restrict borrowings in currencies that do not have a natural hedge or are not one of the most traded currencies globally.

- **Refinancing risk** – the risk that debt will have to be refinanced at an unusually high cost or, in extreme cases, cannot be refinanced at all. To maintain or manage the refinancing risk in the debt portfolio, the government shall prioritise semi-concessional debt with longer maturities. For the Cook Islands, refinancing is governed by the policies of the lenders.

3. Existing Debt Portfolio

The existing portfolio analysis is based on the expected debt balance for FY2022 which includes the policy-based loan from ADB of $55.5 million (Table 1) from December 2021.

Table 1– Cost and Risk Indicators of Existing Debt Portfolio (30 June 2022)

Risk Indicators		Foreign currency debt	Domestic currency debt	Total debt
Amount (in millions of NZD)		98.6	132.4	231.0
Amount (in millions of USD)		68.0	91.4	159.4
Nominal debt as % of GDP		20.4	27.4	47.7
PV[2] as % of GDP		17.6	37.3	54.8
Cost of debt	Interest payment as % of GDP	0.5	1.2	1.7
	Weighted Av. IR (%)	2.4	4.4	3.5
Refinancing risk	ATM (years)	6.8	7.6	7.2
	Debt maturing in 1yr (% of total)	5.1	2.3	3.5
	Debt maturing in 1yr (% of GDP)	1.0	0.6	1.7
Interest rate risk	ATR (years)	3.1	1.0	1.9
	Debt refixing in 1yr (% of total)	55.6	92.6	76.8
	Fixed rate debt (% of total)	48.9	7.9	25.4
FX risk	FX debt (% of total debt)			42.7
Exchange rate (NZD to USD)				*0.690*

Crown debt forecasted to the end of June 2022 at $231 million, or 47.7% of GDP. Gross debt net of LRF is 45.1% of GDP (LRF balance for 2022: $13.8 million) and within the soft cap rule target of Net Debt to GDP of 55%.

The cost of debt in recent years has been relatively low, but this is changing to reflect the changing macroeconomic environment. Most domestic and foreign currency denominated loans are contracted on concessional terms with a weighted average interest rate of 3.5%. This reflects the impact of recently rising interest rates, particularly the key reference rates for the New Zealand Bank Bill Rate. As central banks across the world raise rates to unwind emergency monetary policy and combat rising inflation, these rates are expected to increase, which is borne out in the implied interest rates of all potential strategies below.

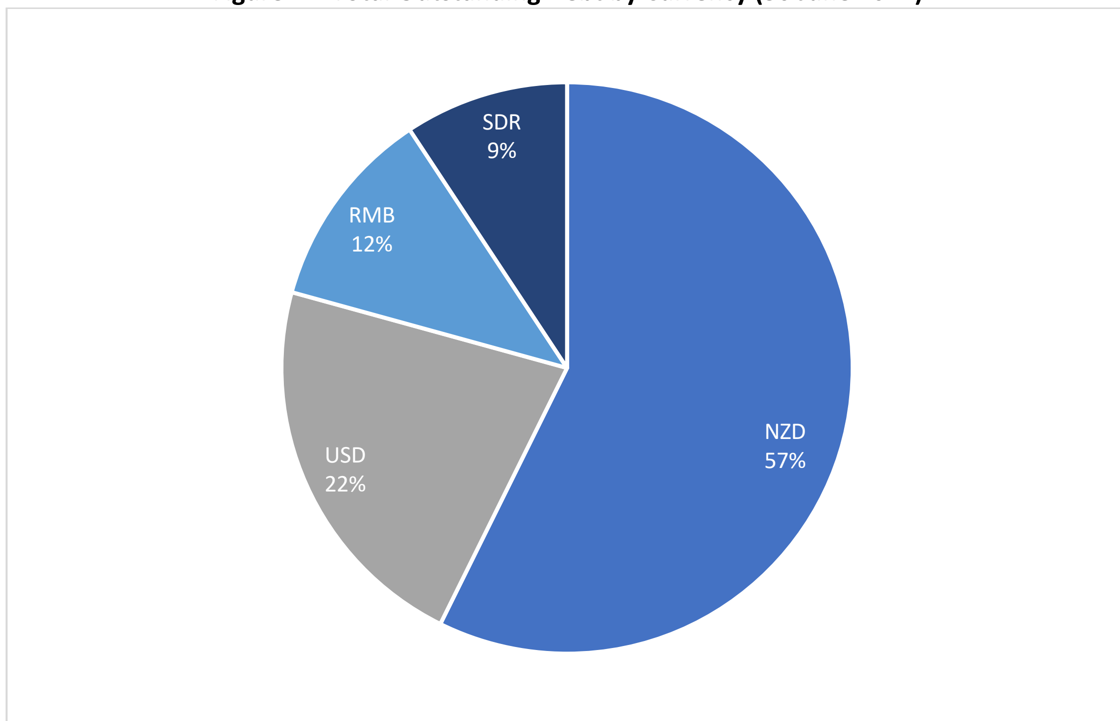
Interest rate risk is the main debt portfolio risk for the Cook Islands. This is due to the large proportion of variable rate debt instruments in the portfolio makes interest rate risk one of the main risks. The shortness in the average time to refixing of total debt of 1.9 years, exposes the portfolio to increasing costs with changing interest rate environments. 92.6% of the domestic currency debt portfolio will be refixing in the next fiscal year as it is linked to floating interest rates, relative to a lower proportion of foreign currency debt. As NZD is the domestic currency used in the Cook Islands,

[2] Discount rate applied is 5%

domestic debt variable interest rates are based on the New Zealand interest rate curve. This curve tends to follow those of foreign markets closer than other Pacific Island domestic markets which tend to be somewhat isolated. These floating rates on NZD denominated debt are expected to see further rises of around one third of one percentage point over the next two years, according to bond market pricing. These increases (if realised) will come with increased costs for existing debt. For foreign-currency denominated debt, 55.6% of the portfolio is linked to floating interest rates, which are also expected to rise in the coming years.

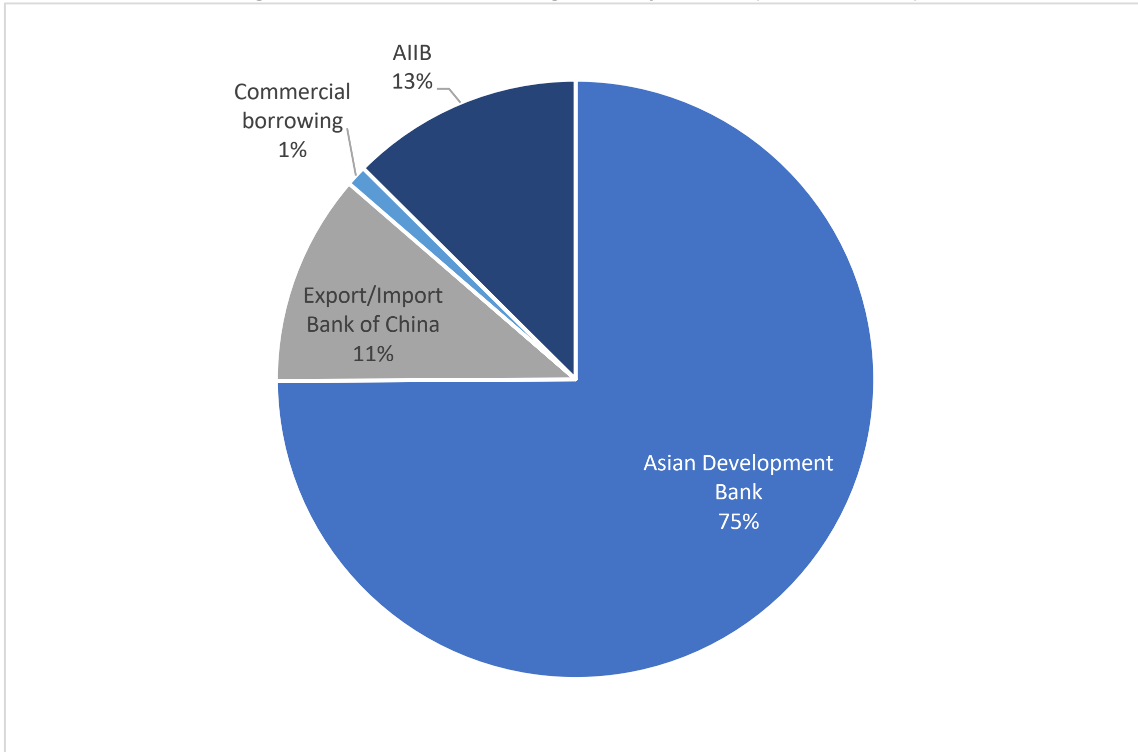
43% of the portfolio is in foreign currency and exposed to exchange rate risk. Much of the exchange rate exposure is to the USD, making up 22% of the total debt portfolio (**Figure 1**). The Cook Islands receive fisheries income in USD (equivalent of NZD$10 million per fiscal year), making for a natural hedge to the exchange rate exposure in the debt portfolio by allocating USD to the LRF based on USD annual debt servicing payments.

Figure 1 – Total Outstanding Debt by Currency (30 June 2022)



A large proportion of existing debt is limited to one multilateral institution (Figure 2). The ADB has provided the large proportion of lending to the Cook Islands, making up 75% of the current debt portfolio. The terms of borrowing have been concessional to date, however increasing limitations in the selection of terms, for example interest rate type and tenor, increases the risk within the debt portfolio. This will be amplified if limitations continue, and diversification of financing sources does not occur.

Figure 2 – Total Outstanding Debt by Lender (30 June 2022)



The repayment profiles (Figure 3, Figure 4, Figure 5 and Figure 6) illustrate the refinancing and interest rate risks of the Cook Islands debt portfolio. The profiles show that the Cook Islands will face increasing refinancing risks from 2024 with a final peak in 2030. The interest rate risk inherent in the portfolio can be seen in **Figure 5**, where the building peak of repayments are variable interest rate debt. Newly contracted, shorter tenure debt has contributed to the building of this peak.

Figure 3 – Principal Repayment Profile by Currency Group
(June 2022, in NZD millions)

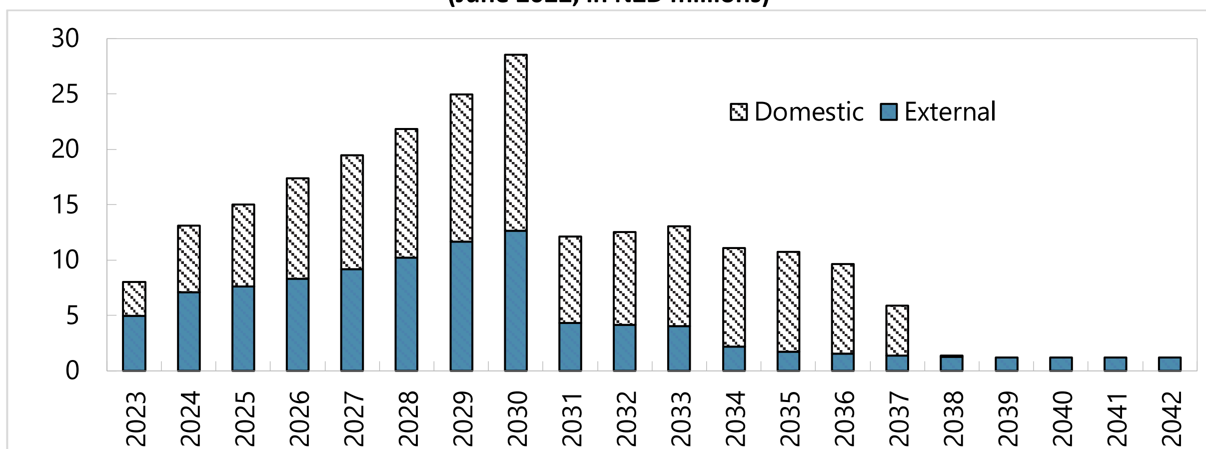


Figure 4 – Overall Debt Servicing Repayment Profile by Currency (June 2022, in NZD millions)

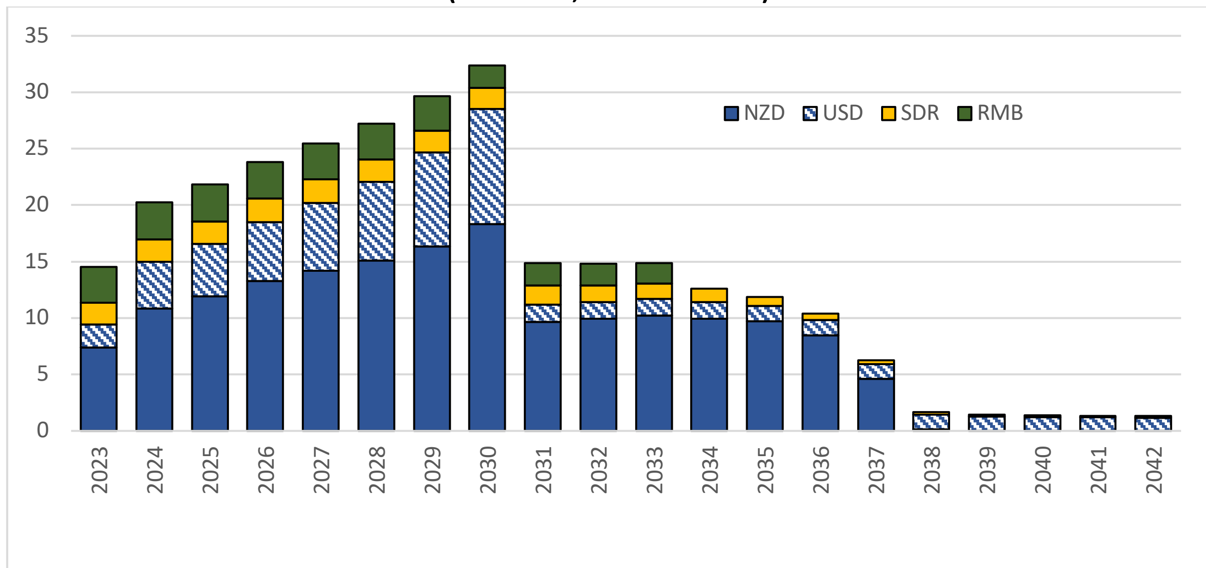
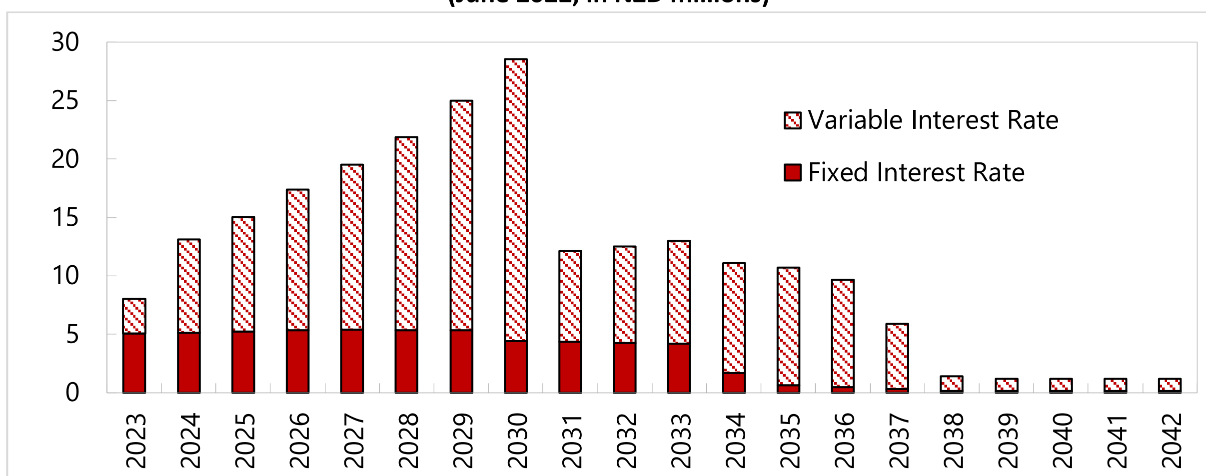
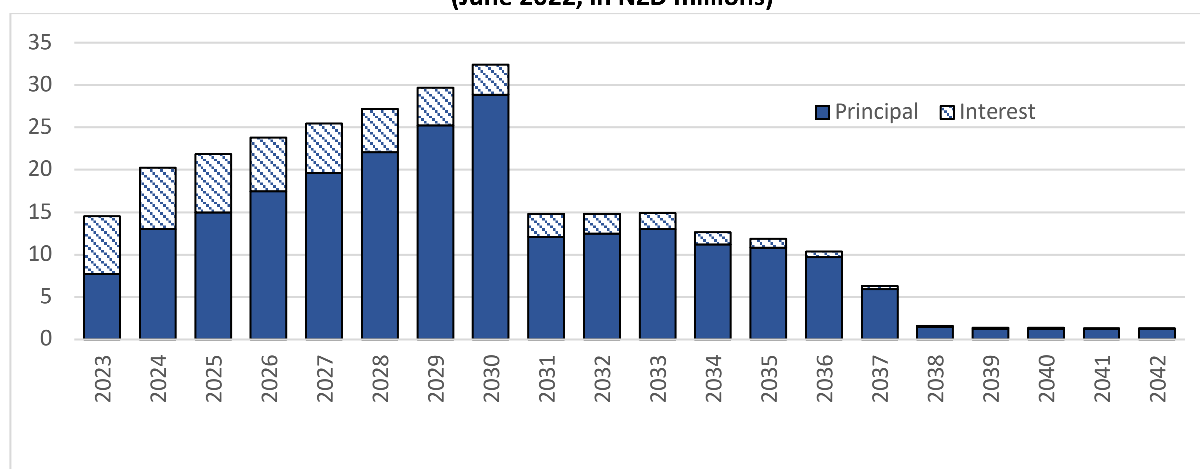


Figure 5 – Principal Repayment Profile by Interest Rate Type (June 2022, in NZD millions)



Refinancing risks from 2024 through 2030 is a concern over the medium-term. With the revised hard cap Net Debt to GDP rule of 65%, there remains room available for the government to take on additional debt if needed, however any new debt must be considered in conjunction with the impact on debt servicing and cash balances. With the current loan portfolio, debt servicing will become a larger concern over the medium-term as grace periods on new debt end and principal repayments begin.

Figure 6 – Overall Debt Servicing Repayment Profile
(June 2022, in NZD millions)



Sources of Financing

Diversification of financing sources for the Cook Islands is crucial to build resilience. A risk factor within the Cook Islands debt portfolio is the lack of diversification of lenders. Exploring partnerships with other bilateral and multilateral institutions, subject to favourable terms and conditions, could provide broader financing options and mitigate the risk of reductions in existing lending programs and limited loan term selection.

The Cook Islands are self-governing state in free association with New Zealand. The Cook Islands is fully responsible for its internal affairs while New Zealand retains some responsibility for external affairs. As such, the Cook Islands cannot access funding from the World Bank Group nor the IMF. Furthermore, on 10 July 2019, the OECD graduated the Cook Islands to the category of High-Income Country, ending eligibility for ODA from 1 January 2020 onwards. **Table 2** below shows the outstanding debt at the end of June 2022 fiscal year.

Table 2 – Total outstanding debt June 2022.

Debt Outstanding (in NZD million)	
ADB	173.1
AIIB	29.0
EXIM Bank China	26.4
Commercial Bank	2.6
Total	**$231.0**

The Cook Islands has no existing domestic capital market and government does not issue any securities. The ADB is the main source of financing in New Zealand dollars, which is used as domestic currency. The small size of the domestic market does not support the development of a domestic debt market, per se. However, issuing Government securities in New Zealand could be an interesting alternative to allow for further diversification of funding sources while minimizing foreign currency risk.

Table 3 – Cook Islands Public Debt Portfolio June 2022

Loans committed and drawn	Date loan taken	Original loan amount (000's)	Expected date of Repayment	Current Balance ($NZD 000's)
ADB 849 (SF) 2nd Multi-Project	December, 1987	SDR 2,150	August, 2027	883
ADB 1031 (SF) Outer Islands Telecom Project	October, 1990	SDR 3,578	August, 2030	2,607
ADB 1155 (SF) 2nd CIDB Project	March, 1992	SDR 1,085	December, 2031	690
ADB 1171 (SF) Emerg. Telecom Rehab Project	August, 1992	SDR 349	June, 2032	241
ADB 1309 (SF) Pearl Industry Dev. Project	December, 1994	SDR 272	August, 2034	296
ADB 1317 (SF) Educ'n Dev Project	February, 1995	SDR 1,852	August, 2034	1,805
ADB 1380 (SF) 3rd CIDB Project	January, 1996	SDR 1,977	September, 2035	1,575
ADB 1466 (SF) Economic Restructure Program	September, 1996	SDR 3,430	September, 2036	3,649
ADB 1588 (SF) Cyclone Emergency Rehab Project	January, 1997	SDR 583	January, 2038	651
ADB 1832 (SF) Waste Mgt Project	December, 2001	SDR 1,695	June, 2033	1,455
ADB 2174 (SF) Cyclone Emergency Assist Project	June, 2005	SDR 1,895	June, 2045	3,060
China - Multi-Functional Indoor Sports Stadium	August, 2008	RMB 74,100	August, 2028	6,879
ADB 2472 (OCR) Avatiu Port Development Project	September, 2009	NZD 10,309	November, 2033	7,907
ADB 2473 (SF) Avatiu Ports Development project	September, 2009	SDR 4,524	November, 2040	4,561
ADB 2565 OCR Economic Recovery Support Program 1	January, 2010	NZD 11,053	October, 2024	2,512
ADB 2739 (OCR) Amendment Avatiu Port project	December, 2011	NZD 5,290	November, 2035	4,542
China - Rarotonga Water Ring Main Upgrade	December, 2012	RMB 118,000	December, 2032	19,529
ADB 2946 OCR Economic Recovery Support Program 2	December, 2012	NZD 11,053	October, 2027	3,323
ADB 3193 Renewable Energy Project	December, 2014	NZD 12,980	June, 2036	9,947
ADB 001-COO(FA-CDF) - Disaster Resilience Program	December, 2019	NZD 15,676	June, 2035	15,676
ADB 3632 - Loan for Undersea Broadband Cable	November, 2018	USD 15,000	October, 2042	21,739
Commercial - Loan for Rarotonga Airport Equipment	January, 2018	NZD 3,206	2033	2,559
ADB 4010 - CPRO Loan	November, 2020	NZD 30,409	June, 2030	30,409
AIIB - CPRO Loan	December, 2020	USD 20,000	June, 2030	28,986
ADB 4161 - Sustainable Economic Recovery Program	December, 2021	NZD 55,540	December, 2036	55,540
Total Loans Drawn Down				**231,018**
Contingency Loans				
ADB 4162 - Precautionary Financing Option (PFO)	December, 2022	NZD 55,540	December, 2037	55,540
ADB - Disaster Resilience Program (Phase 3)	December, 2022	NZD 30,312	June, 2037	30,312
Total Committed/Planned but Undrawn				**85,852**
Total Loans Commitment by the Crown				**316,870**

Foreign Currency Sources of Financing

The main source of foreign currency financing to the Cook Islands comes from the ADB. The ADB historically provided financing to the government in two currencies: USD and SDR[3]. Borrowing in the form of SDR denominated loans was the main source of financing for the Cook Islands up to 2009 when the country switched to funding in USD. All loans in SDR came with very concessional terms with

[3] The Special Drawing Right (SDR) is unit of account, that functions similar to a very specialized currency. Its value is determined by a weighted combination of five international currencies – USD, EUR, RMB, JPY and GBP. It is only used by multilateral institutions.

40 years maturity and 10 years grace period and 1 percent interest rates. Since 2009, Government has contracted two loans in USD (in 2014 and 2021) under less concessional financial terms.

Another source of foreign currency financing comes from the Asian Infrastructure Investment Bank (AIIB). The AIIB provided one loan to the Cook Islands under the countercyclical support facility using COVID-19 Active Response and Economic Support Program. The loan was issued in USD under commercial terms with 9.5 years maturity including 3 years grace period and floating interest rates based on LIBOR.

Additional source of foreign currency financing has been EXIM Bank, China. It has extended two loans to the Cook Islands in 2008 and 2012 respectively, under semi concessional terms with 20 years maturity and 5 years grace period and fixed interest rates of 2%. The two loans were extended in the Chinese currency – RMB.

Potential other sources of financing are at varying stages of readiness to lend to the Cook Islands (if needed) and include the Australian Infrastructure Financing Facility for the Pacific (AIFFP) as well as other potential bilateral relationships.

Domestic Currency (NZD) Sources of Financing

As with foreign currency borrowing, the main source of funding in NZD for Cook Islands is the ADB. Since 2009 it has been providing most of its financing in NZD except for two operations in USD described above. Lending in NZD to the Cook Islands comes with an average maturity of 20 years and include a 3-year grace period. Interest rates associated with these loans are mostly floating with LIBOR + 0.8% spread. Financing terms of the newer loans have come in less concessional terms since Cook Islands became non-eligible for ODA in 2019, with an average of 12-year maturity, 3-year grace period and LIBOR +0.3% in interest rates. More recent debt has been linked to New Zealand bank bill rates rather than LIBOR, creating a closer link to the cost of NZD denominated debt.

The Cook Islands signed two contingency domestic loan facilities with the ADB. The two loans are not included in the public debt portfolio analysis because they have not been disbursed, totalling $85.8 million:

1. Disaster contingency loan of $30.3 million that will only be drawn in the event of disasters triggered by natural hazards or health emergencies.
2. Precautionary financing loan (ADB) of $55.5 million to support government's cashflow when pre-established conditions are met.

Another recent source of financing for an SOE, the Airport Authority, has come from a private commercial bank in the Cook Islands. This loan has come with a 15-year maturity and a fixed interest rate of 5.25%.

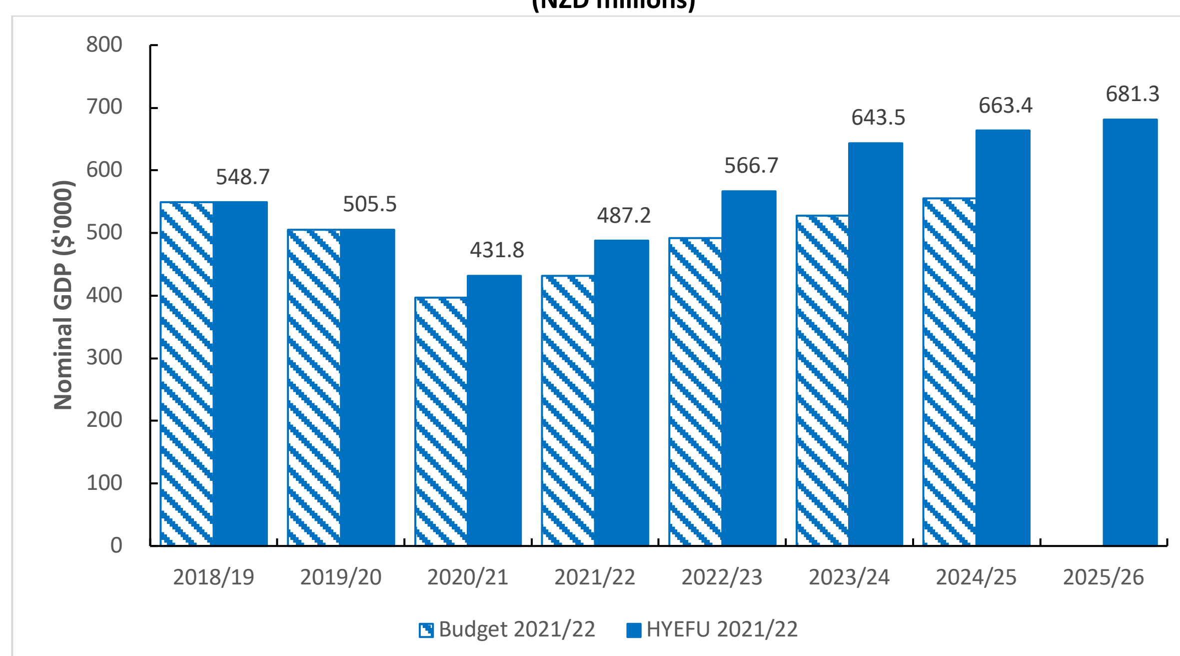
4. Economic Environment

The Cook Islands is in a free association with New Zealand, adopting the NZD as its currency and with no central bank, limiting monetary policy abilities. As the Cook Islands have adopted the NZD as the local currency and lack a central bank, fiscal policy is the only macroeconomic-policy lever available to the government. New Zealand monetary policy therefore influences the Cook Islands economy through interest and exchange rates.

Government-led economic support has been provided through stimulus packages during COVID-19. The economic stimulus package provided relief in the 2021 financial year of 18.8% of GDP (or $80.8 million), after the 2020 financial year had $17.7 million (3.5% of GDP) in response to the start of the pandemic. Further stimulus in the form of the Economic Recovery Roadmap (ERR) will provide further economic support in 2022 of 9.2% of GDP (or $45.0 million) before fiscal policy is expected to take a more neutral stance in 2023. The total economic stimulus package is estimated to total $143.5 million over the course of the pandemic.

Forecast Nominal GDP is now considerably stronger than estimated in the 2021/22 Budget. This is largely a consequence of a 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 travel bubble with New Zealand 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% 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% 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 7 – Nominal GDP forecast comparisons – 2021/22 Budget versus 2021/22 HYEFU (NZD millions)



Primary deficit is expected to decrease over the forecast period. As outlined in the 2022/23 Budget, the budget outlook is expected to recover from the large expenditure increases and revenue decreases through the COVID-19 pandemic which saw a fiscal deficit of $93.5 million in the 2020/21 year (22.9% of GDP). By the 2024/25 year, this fiscal balance is expected to be a surplus of $3.4 million, or 0.5% of GDP[4].

Support by development partners during the pandemic has totalled $112.2 million. Aid support to the Cook Islands since March 2020 totalled $112.2 million, approximately 14% of GDP. Despite the recent graduation of the Cook Islands from ODA, development partners have provided support during the pandemic and continue to help with budget support. This support provides a relief from debt funding, however future support amounts are not known. This has been augmented by $130.6 million in additional debt taken on to fund support and government programs.

Key Risk Factors

The macroeconomic forecast is vulnerable to downside risks. The risks that might arise from potential domestic and external shocks are presented below and summarised in the risk assessment matrix (**Table 4**).

Immediate risks and challenges relate to the COVID-19 impact and supporting economic recovery. The continued impact of COVID-19 on border closures and economic support packages, will constrain growth and place increasing pressure on fiscal indicators, increasing the gross financing requirements. Although the direct health impact of COVID-19 to the Cook Islands has been small, the downside risk to macroeconomic and fiscal sustainability remains with sustained border closures and economic support. The continued aid of development partners by way of grants will support of the mitigation of any persistent COVID-19 impacts.

Other key downside risks may hinder the economic recovery. Climate change and natural disasters are a well-known risk in the Pacific Islands. Direct economic losses from natural disasters often exceed 10% of GDP in developing countries. Although the Cook Islands utilise a Stabilisation Account, with appropriated funds for the use in periods of economic downturn or natural disasters, the recent COVID-19 economic impact exhausted these emergency funds. Regional catastrophe insurance and emergency loans are also utilised in qualifying events. A natural disaster occurrence before the Stabilisation Account has returned to pre-COVID-19 levels, could also significantly affect Cook Islands' economic growth and fiscal balances.

Table 4 – Risk Assessment Matrix

Risks	Likelihood of Risk Event	Implication for Debt Management Strategy
Growth Border restrictions return after the January 2022 opening, dampening growth.	Low to Medium	Increased fiscal requirement and potentially breach net debt rule.

[4] Based on balance from the 2021/22 Budget, with GDP forecast updated.

Risks	Likelihood of Risk Event	Implication for Debt Management Strategy
Inflation Inflation, driven by imported inflation, is higher than projected.	Medium	Debt service costs may increase if yield curve adjusts to higher inflation.
Rising interest rates on NZD In response to growing inflation in New Zealand, the RBNZ continues to raise interest rates, pushing the yield curve up.	High	Debt service costs will increase in response to the higher bank bill rates. The Cook Islands has $101.6 million in NZ bank bill rate linked debt as at June 2022.
Rising LIBOR interest rates Throughout much of the world, inflation concerns are rising and this has begun to lead to LIBOR raising in response to central bank action.	High	Debt service costs will increase in response to the higher bank bill rates. The Cook Islands has $68.4 million in LIBOR-linked debt as at June 2022.
Fiscal Border restrictions continue, limiting forecast revenue, and continued requirement for economic stimulus packages. Recovery of tourism-focused business is slower than anticipated, necessitating extended government support to the industry	Low to Medium	Gross financing needs may increase due to higher fiscal deficits.
Financial System Continued financial impact of COVID-19 requires further government support through the Business Continuity Credit Facility and Interest Relief-type programs.	Medium	Gross financing needs may increase due to higher fiscal deficits.
Access to credit With the increase in borrowing through COVID-19, the ADB and other potential creditors may be unwilling to extend further credit if needed.	Low to Medium	This may increase costs of any new debt, if it is available.

5. Cost-Risk Analysis of Alternative Debt Management Strategies

The MTDS considered four financing strategies under the baseline assumptions and alternative shocks to baseline interest and exchange rates.

Table 5 – Strategy description MTDS 2022-2026

Strategy 1 (S1)	The first Strategy uses government's existing source of financing (ADB) and implements a policy for funding only in local currency (NZD) and on variable interest rates. Therefore, all the financing needs for the period will come from this funding source in domestic currency.
Strategy 2 (S2)	The second Strategy uses the same source of financing and same currency as Strategy 1 but only fixed interest rates. This was designed to assess the difference, in terms of cost and risk, between borrowing with variable interest rates and fixed interest rates.
Strategy 3 (S3)	The third strategy was designed to test using alternative sources of financing. Strategy three assumes that half of the financing will come from government issued 1 and 2-year securities in NZD and the other half will come using the same instrument as in Strategy 1 – loans in local currency (NZD) from multilateral sources with variable interest rates.
Strategy 4 (S4)	Strategy four, assumes 10% of the financing will come from foreign currency loans secured in semi-concessional terms from bilateral development partners. The remaining ninety per cent would remain from the sources in Strategy 1 and Strategy 2 – loans in local currency (NZD) from multilateral sources with variable interest rates (70%) and fixed interest rates (30%).

The cost and risk indicators will be affected as the portfolio composition changes through the borrowing mix during the strategy's time horizon. Table 6 below depicts how these indicators are projected for each of the strategies, as compared to current status. Under each strategy, the debt to GDP ratio remains fairly stable throughout the period. The overall trend for the debt/GDP indicator is mostly a consequence of the fiscal policy, which is not within the scope of decision making for the debt manager and the debt management strategy.

Table 6 – Cost and Risk Indicators under Alternative Strategies

Risk Indicators		2022	As at end 2026			
		Current	**S1**	**S2**	**S3**	**S4**
Nominal debt as % of GDP		47.7	46.6	47.0	46.9	**46.6**
Present value debt as % of GDP		54.8	58.0	66.1	56.0	**58.7**
Interest payment as % of GDP		1.7	1.8	2.0	2.0	**1.8**
Implied interest rate (%)		3.5	4.2	4.7	4.5	**4.2**
Refinancing risk	Debt maturing in 1yr (% of total)	3.5	6.9	6.1	15.5	**6.6**
	Debt maturing in 1yr (% of GDP)	1.7	3.2	2.9	7.2	**3.1**
	ATM External Portfolio (years)	6.8	4.6	4.6	4.6	**5.6**
	ATM Domestic Portfolio (years)	7.6	6.9	9.5	5.7	**7.5**
	ATM Total Portfolio (years)	7.2	6.4	8.4	5.5	**7.0**
Interest rate risk	ATR (years)	1.9	0.9	6.5	1.0	**2.9**
	Debt refixing in 1yr (% of total)	76.8	89.8	45.1	85.5	**73.4**
	Fixed rate debt (% of total)	25.4	11.9	56.5	25.1	**28.3**
FX risk	FX debt as % of total	42.7	22.1	21.9	22.0	**26.5**

The focus of the MTDS is directed towards mitigating the two main risks to the public debt portfolio (i) high interest rate, due to the high proportion of floating interest loans (2022: 74.6%), and (ii) the average time to maturity, due to the impact of the high annual debt service repayments have on the government's cashflow.

The baseline to the alternative strategy reliant on fixed interest rates (S2) shows the highest cost, while S1 and S4, which include financing on semi-concessional terms show the lowest cost. S3 show similar cost structure although, incorporating issuance of government Securities in the NZ market, shows a slightly higher cost.

S1 and S4 are forecasted with the lowest implied interest rate of 4.2% by the end of FY2026, however S4 has a longer ATM of 7 years compared to 6.4 years for S1. It is therefore concluded that S4 demonstrated the optimal mix of debt financing by reducing interest rate risks whilst also improving ATM.

6. Debt Management Strategy 2022-2026

Description of strategy for the period 2022-2026

The MTDS has been chosen from the cost-risk analysis carried out on the public debt portfolio. The result of the analysis demonstrated interest rate risk is the main debt portfolio risk for the Cook Islands followed by refinancing risk. Strategy 4 offers a good mix of debt financing by reducing interest rate risk of the portfolio whilst maintaining similar level of ATM compared to the other strategies. The exposure to exchange rate risk is effectively being managed through the natural hedging process described earlier and through the requirements of the LRF Act. The refinancing risk has a potential to increase if the pandemic continues to affect economic recovery.

Potential funding sources and Crown's planned borrowings 2022-2026. To meet the Crown's financing needs, government borrowing should continue to prioritise highly concessional external sources of financing, if it is available, maximising on the potential allocation available from existing multilateral financial institutions. Noting that access to concessional financing is subject to the Cook Islands country credit classification.

Table 7 – Financing Needs Assessment 2022/23

Financing Requirements	**2022/23**	**2023/24**	**2024/25**	**2025/26**
Net Operating Balance	($19,391)	($684)	$5,486	$17,107
Net Non-Operating Balance (excl debt)	($40,483)	($29,230)	($28,734)	($30,295)
Depreciation	$13,767	$13,783	$13,783	$13,783
Payments made from LRF	$728	$759	$772	$772
Financing Requirements (excl debt)	**($45,379)**	**($15,373)**	**($8,693)**	**$1,367**
add: General Cash Reserves (start)	*$45,379*	*$15,373*	*$4,827*	*$0*
add: Debt Financing	*$0*	*$0*	*$0*	*$0*
Financing Gap	**$0**	**$0**	**($3,866)**	**$0**

Financing needs assessment for the period ending 2026. Government will need to return a cash positive balance budget either by seeking additional grants from international donors, reduce spending or take on new debt. The estimated financing requirements for the four-year time horizon is approximately $3.9 million and demonstrated government's commitment to prioritising spending within the context of economic recovery.

The MTDS dictates that the optimal borrowing structure is a mix of debt instruments with both variable and fix interest rate loans. However, the government has already signed a Precautionary Financing Option (PFO) loan facility with the ADB in December 2021 for $55.5 million, if accessible, this should be sufficient to accommodate the financing needs over the four-year period ending 2026. However, this relies on certain triggers to be available. The PFO loan provides rapid financing if market conditions supporting the economic and fiscal recovery deteriorate at short notice, as determined by macroeconomic conditions, the facility will be available until December 2024. The PFO loan terms are in the local currency, 15-year repayment tenure with variable interest rates.

The Cook Islands Country reclassification with the ADB. The Cook Islands has recently been reclassified from Group C – eligible for regular OCR only to Group B will allow access to more concessional financing terms. ADB's Graduation Policy classifies DMCs into three groups. In general:

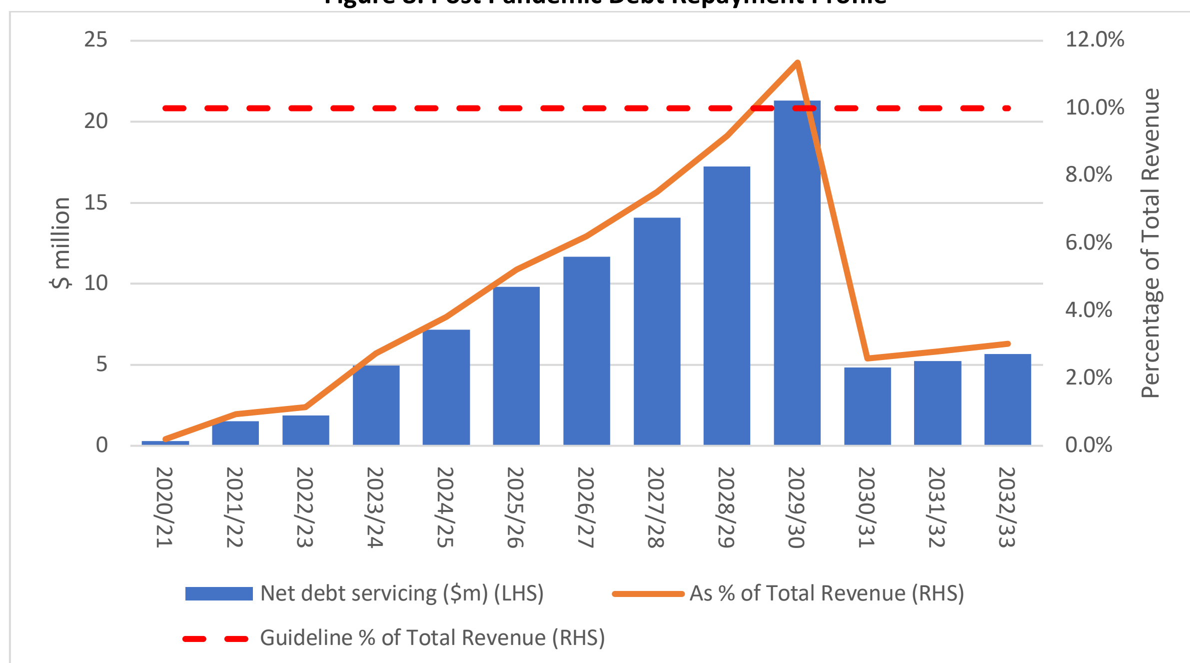
- **Group A** DMCs are eligible only for concessional assistance including Asian Development Fund (ADF) grants based on country debt sustainability or risk of debt distress.
- **Group B** for a blend of concessional and regular ordinary capital resources (OCR) loans plus limited access to ADF grants, and
- **Group C** are eligible for regular OCR only.

There is a potential to refinance the public debt portfolio based on the country reclassification. As a result of reclassification to Group B classification, the Cook Islands will have access to more concessional financing terms and an opportunity to assess the public debt portfolio and could open discussions regarding a preference to refinance loans that were signed with short term maturities, specifically post pandemic loans:

1. ADB CPRO loan $30.4 million – 7 years repayment (10 years incl 3 years grace)
2. AIIB CPRO loan US$20 million – 7 years repayment (9.5 years incl 3 years grace)
3. ADB PBL $55.5 million – 12 years repayment (15 years incl 3 years grace)

While government are very grateful to our creditors in the ADB and AIIB, the need for funding in the crisis meant there was little choice but to undertake these loans at those terms. As illustrated on Figure 7, the post pandemic loans alone are estimated to have a combined annual debt service repayments of $9.8 million by 2025/26 – about 5.2% of total revenue with an expected increase to reach $21.3 million by 2029/30 – just above 10% of total revenue.

Figure 8: Post Pandemic Debt Repayment Profile



Strategic targets

The key targets for the MTDS 2022-2026 are as follows:

1. Maintain total Crown debt as a share of GDP well below the 65% threshold, by redefining the conditions of new borrowing, prepaying debts from LRF where applicable, and maintaining prudent macroeconomic management.

2. New borrowing should be limited to priorities reflected in the National Infrastructure Investment Plan 2021-2030 (NIIP) identified through the National Budgets and considered only for investments that can demonstrate a positive economic return sufficient to match interest and repayment costs. Economic assessments need to occur in early stages of project preparation through government's activity management system – Tarai Vaka Process (TVP).

3. To minimise impact of costs and risks to government, these indicators shall be used as a guideline to provide measurable and quantifiable targets for monitoring purposes.

Table 8 – Key Targets 2023 - 2026

	Indicators	Current level	Target – overall debt	Target – new debt
Interest rate risk	1. Implied interest rate	3.6%	<4.5%	<4.5%
	2. % of total debt in variable interest rates	74.9%	<70%	<65%
Refinancing risk	3. Limit total public debt maturing in 1 year	3.5%	<6%	<5%
	4. Total Average Time to Maturity	7.3 years	>7 years	>15years
Exchange rate risk	5. foreign debt as a % of total debt	42.0%	<30%	<10%

4. Complete the application process for country reclassification review with the ADB by 2022/23.

5. Complete a white paper on the feasibility of setting up the domestic debt market in the Cook Islands by 2022/23 or issuing government securities in New Zealand to utilise the larger market for NZD securities.

6. The Debt Management Unit (DMU) should be appropriately staffed, adequately trained and resourced to conduct the debt management functions articulated in staff job descriptions.

Monitoring and evaluation

The MTDS has a time horizon of 4 years, a review of progress will be carried out annually. A review of government's progress against the MTDS key targets will be reported annually through the budget process. Due to the uncertainties of the current economic environment, it is possible that a revised MTDS may be necessary once we have a clear direction on the road to recovery before the end of the MTDS term.