Republic of Cyprus
Rating Report

SCOPE BBB STABLE OUTLOOK

Credit strengths	Credit challenges
• Strong growth potential • Prudent fiscal management and favourable debt trajectory • Structural reform momentum	• Externally dependent, concentrated economy • Banking sector vulnerabilities • High public and private debt

Rating rationale:

Strong growth potential: Cyprus benefits from its strong medium-term growth potential which has underpinned one of the highest growth rates in the euro area. Growth is supported by sound macro-economic policies, improving labour market conditions as well as foreign-financed investment in important sectors.

Solid fiscal consolidation prospects: Cyprus has a good fiscal consolidation record characterised by consistent fiscal surpluses, overachieving fiscal targets, and marked debt reduction. Renewed commitment to fiscal discipline and a robust growth outlook underpin a very favourable debt trajectory.

Sound structural reform momentum: Cyprus's stable and reform-oriented government has achieved considerable progress in implementing reforms to address imbalances in the economy following the 2012-13 crisis. Good progress on the government's reform agenda and under its National Reform and Recovery and Resilience plans will address structural challenges and enhance economic resilience.

Rating challenges include: i) a small, externally dependent, and concentrated economy; ii) lingering though improving vulnerabilities in the banking sector; and iii) high public and private debt levels combined with large external imbalances. These factors increase Cyprus's sensitivity to shocks.

Cyprus's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	a-	EUR [+1]	0	BBB
Public Finance Risk		20%	aa+		+1/3	
External Economic Risk		10%	c		-3/3	
Financial Stability Risk		10%	aa-		-2/3	
ESG Risk	Environmental Factors	5%	bbb+		-1/3	
	Social Factors	7.5%	a		0	
	Governance Factors	12.5%	bbb		-1/3	
Indicative outcome			**a-**		**-2**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced.

Positive rating-change drivers	Negative rating-change drivers
• Sustained fiscal consolidation • Further reduction in banking sector vulnerabilities • Reduced sensitivity to external shocks	• Growth outlook deteriorates substantially • Fiscal fundamentals weaken significantly • Banking sector fragilities re-emerge

Ratings and Outlook

Foreign currency

Long-term issuer rating	BBB/Stable
Senior unsecured debt	BBB/Stable
Short-term issuer rating	S-2/Stable

Local currency

Long-term issuer rating	BBB/Stable
Senior unsecured debt	BBB/Stable
Short-term issuer rating	S-2/Stable

Lead Analyst

Thibault Vasse
+33 1 86 26 24 55
t.vasse@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389-0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

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Domestic Economic Risks

- **Growth outlook:** The Cypriot economy has been remarkably outperforming expectations growing by 6.2% in the four quarters to September 2022. This was thanks to faster-than-expected recovery in tourism and sustained expansion in exports of other services, notably business services and IT. Arrivals of tourists and revenues increased considerably in the first months of 2022 and reached around 75% of pre-pandemic levels. The Russia-Ukraine crisis presents an important risk given reliance on Russian and Ukrainian tourists, but the economy has demonstrated its resilience and has diversified to other tourism markets. Medium-term growth will be supported by the EUR 1.2bn (4.3% of GDP) Recovery and Resilience plan. We project growth of 5.5% in 2022, after 6.7% in 2021. Growth should then moderate to 2.7% in 2023 and stabilise at around 3% thereafter.

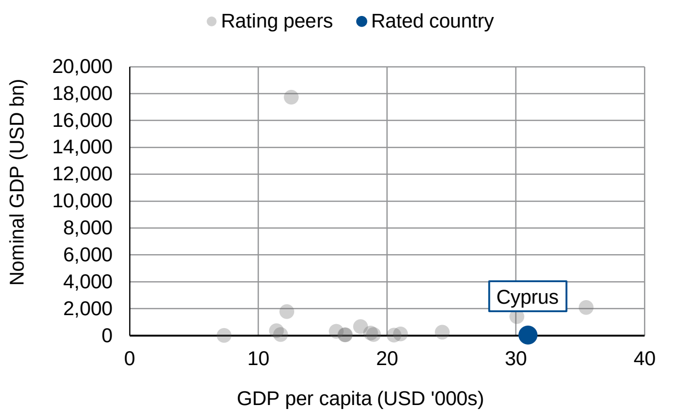
- **Inflation and monetary policy:** Cyprus is facing surging commodity prices, and a rising import bill for minerals, oil, fuel and cereals. The inflationary impact of rising commodity prices could be exacerbated through higher wage growth given that the country has a partial wage indexation mechanism, the Cost-of-Living Allowance. Despite Cyprus's import dependence for key commodities, it has so far been well insulated from inflationary pressures relative to other EU countries. In September 2022, inflation stood at 9% versus a 12.9% EU average while core inflation was lower at 6.2%. Like other major central banks, the ECB has been rapidly tightening its monetary policy to tame price pressures. Key ECB interest rates increased by 75 bps in both September and October 2022, with the deposit rate reaching 1.5%. This is the highest level since 2009, 200 bps higher than in 2019, and we expect additional interest rate increases.

- **Labour markets:** Labour markets have shown signs of weakening in recent months. The seasonally adjusted unemployment rate reached 8% in September 2022, up from 6.2% in September 2021. We expect unemployment to average 7% in 2022 and then gradually decline to 6% by 2027, thanks to steady growth. In August 2022, the government agreed to implementing a minimum wage at EUR 885 from January 2023m which is set to rise to EUR 940 six months later. This, combined with the automatic wage indexation mechanism should help support living standards among households.

Overview of Scope's qualitative assessments for Cyprus's *Domestic Economic Risks*

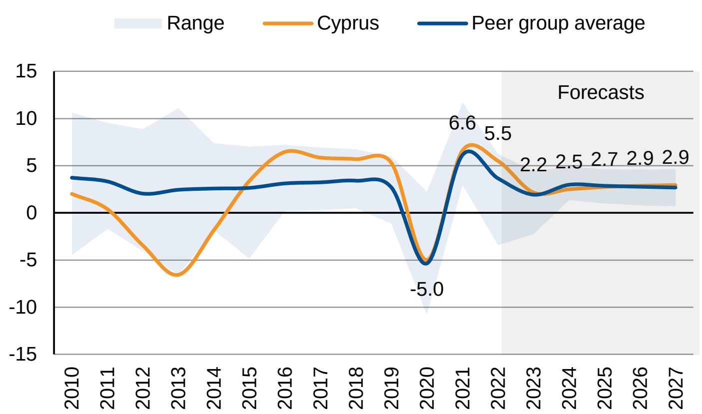
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Growth potential of the economy	Strong	+1/3	Strong growth potential supported by improving labour markets, foreign investment and reform
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; accommodative policies adequately support the economy.
	Macro-economic stability and sustainability	Weak	-1/3	Economic structure exposed to volatility; long-term sustainability of growth reliant on foreign funding or external demand

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

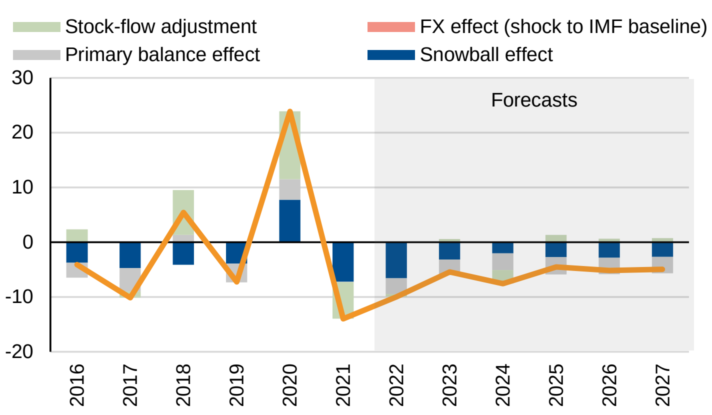
Public Finance Risks

- **Fiscal outlook:** Cyprus's fiscal position has improved markedly since the height of the Covid-19 pandemic. The budget balance improved rapidly to -1.2% of GDP in 2021 from -5.8% of GDP in 2020. This was thanks to better-than-expected revenue underpinned by the strong economic rebound as well as withdrawal of pandemic support measures. We expect the inflationary effects of the Russia-Ukraine war to have a limited impact on Cyprus's budgetary performance. Expenditures will rise moderately given the indexation of public wages and pensions while support to mitigate the cost-of-living crisis for households and businesses totals EUR 0.3bn (1.2% of GDP). Conversely, inflation will also expand VAT tax revenue. We expect the budget balance to reach 1.2% of GDP in 2022 and further improve steadily to 2% of GDP by 2027.
- **Debt trajectory:** Cyprus's debt trajectory is very favourable compared to euro area peers. In 2021, public debt decreased by almost 14pps of GDP, reaching 101% of GDP. Improving fiscal performance, strong economic growth and the expected reduction in Cyprus's large cash buffer will support a rapid reduction in the debt-to-GDP ratio. Our baseline projects debt to reach pre-pandemic levels in 2022 and continue to decrease to 63% of GDP by 2027, one of the strongest debt reductions in the EU. Even under a stressed scenario that includes a substantial macro-fiscal shock and higher funding costs, debt is expected to decline to 86% of GDP.
- **Debt profile and market access:** Cyprus benefits from a favourable debt profile supported by its pro-active debt management strategy. As of July 2022, Cypriot public debt had a low share of short-term debt (1%), no foreign currency exposures, limited interest rate risks (71% of debt is fixed rate) and a long weighted average maturity of 7.7 years. Rising inflation and ECB monetary policy tightening is pushing up financing rates with the 10-year government bond yield at 4.3% on 7 June 2022, versus 0.7% at the beginning of the year and the highest since 2016. In addition, a large cash buffer, covering almost three years of debt redemptions provides additional funding flexibility.

Overview of Scope's qualitative assessments for Cyprus's *Public Finance Risks*

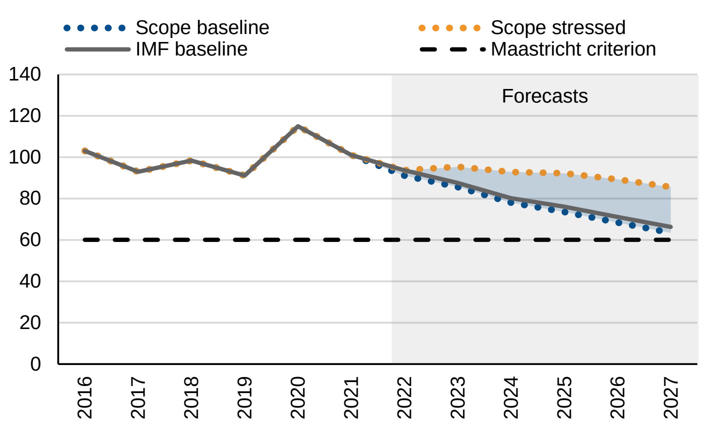
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Fiscal policy framework	Strong	+1/3	Good record of effective fiscal consolidation and overperforming fiscal targets, strong fiscal outlook
	Debt sustainability	Neutral	0	Elevated public debt; sharp increase in indebtedness due to Covid-19 crisis; very favourable debt trajectory
	Debt profile and market access	Neutral	0	Low interest payment burden, rising average maturity and improving investor base

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

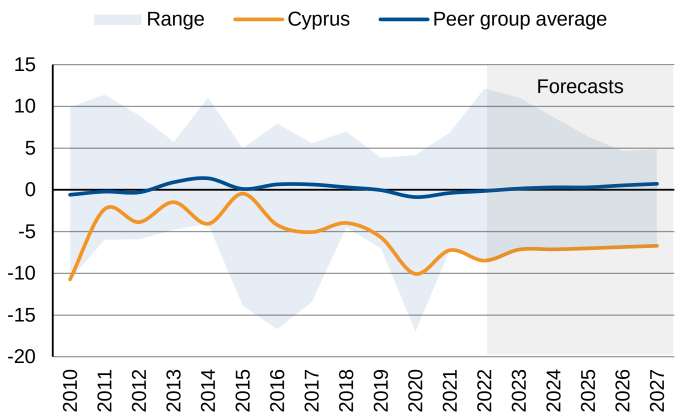
External Economic Risks

- **Current account:** Cyprus's current account is characterised by wide deficits driven by high levels of net goods imports which are only partly offset by high levels of net services exports. This reflects Cyprus's status as a tourism destination, financial service hub and as a resource constrained island state. The current account deficit dropped to 6.8% of GDP in 2021 from 10.1% of GDP in 2020 thanks to recovery in exports, in particular from tourism. The current account will stabilise over the medium term given the deteriorating terms of trade and a recovery in imports, underpinned by domestic economic expansion, mitigated by recovery in tourism and other export sectors. We expect the current account to average -7.2% of GDP over 2022-27, versus -3.9% of GDP over 2015-19.
- **External position:** Cyprus's external position is weak. The net international investment position was very negative but has improved recently at -107% of GDP Q1 2022 (-34% of GDP after adjustment for the impact of SPEs), versus -126% of GDP (-46% of GDP) in Q1 2021. This remains a source of vulnerability and warrants monitoring. Cyprus' external debt is high, at 640% of GDP in June 2022 but has declined substantially in recent years, falling from the peak of 1256% of GDP in Q4 2015.
- **Resilience to shocks:** As a small, open economy which is highly depending on foreign funding and foreign demand, Cyprus remains exposed to short-term external shocks. This, combined with the external vulnerabilities highlighted above and large external gross financing needs present a risk to the Cypriot economy which remains exposed to liquidity and other risks as highlighted by the IMF. Euro area membership bolsters resilience to short-term shocks however.

Overview of Scope's qualitative assessments for Cyprus's *External Economic Risks*

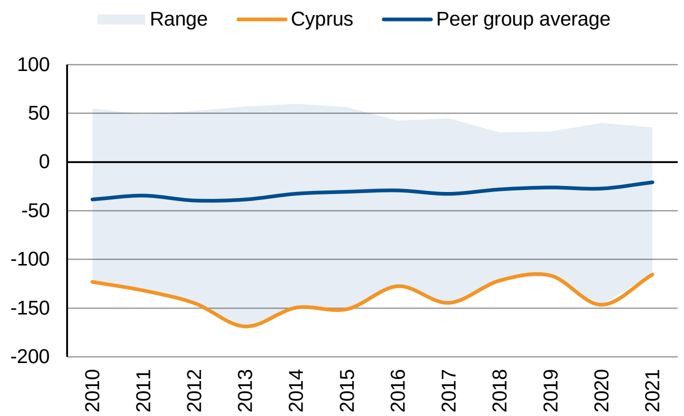
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
c	Current account resilience	Weak	-1/3	Consistent current account deficits with exports concentrated in a few key sectors
	External debt structure	Weak	-1/3	Large external debtor position and high external financing needs exacerbated by current account deficits
	Resilience to short-term external shocks	Weak	-1/3	Large external gross financing needs exposes the country to liquidity and other risks; euro area membership bolsters resilience to shocks

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

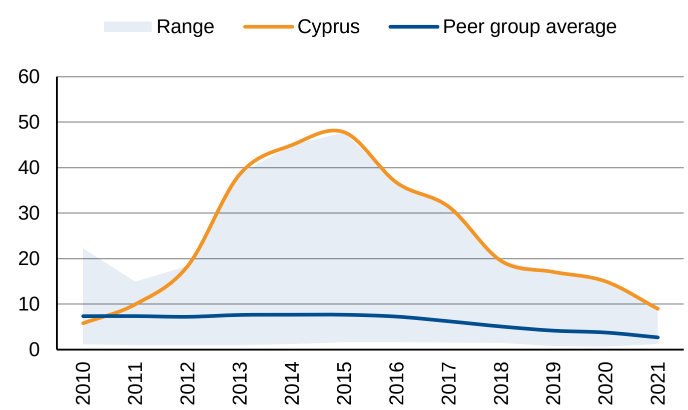
Financial Stability Risks

- **Banking sector:** Cyprus's banking sector resilience has continued to improve though the Covid-19 pandemic has temporarily halted progress. Capitalisation is sound and remains in line with pre-crisis levels, with an aggregate tier 1 ratio of 18.9% in March 2022. The nonperforming loan (NPL) ratio stood at 9.4% in March 2022, down from 15.2% in March 2021 with further sales of NPLs expected to further reduce this ratio. The banking sector continues to suffer from low though improving profitability. Financial exposure to Russia is limited with 3.8% of deposits belonging to Russian nationals and 0.8% of loans in Cyprus banks exposed to Russia. One key risk is the re-emergence of fragilities and an increase in NPLs given rising interest rates. Risks for the sovereign are mitigated by the country's favourable economic outlook and the banking sector's much smaller size compared to the previous banking crisis.
- **Private debt:** High private debt remains an important vulnerability though Cyprus has been deleveraging substantially in recent years. Household debt, at 79% of GDP in Q2 2022, is the fourth highest in the EU but is well below the 2013 peak of 130% of GDP. Similarly, consolidated nonfinancial corporate debt remains high at 160% of GDP as of Q2 2022, against the 2015 peak of 223% of GDP but well above the euro area average (81% of GDP). Cyprus is among the European countries whose household sector is the most vulnerable to unexpected shocks with 43% of households reporting their inability to meet an unexpected, required expense, according to EU Statistics on Income and Living Conditions surveys.
- **Financial imbalances:** Risks related to the real estate sector appear limited for now given broad stability in residential prices in recent years. Cyprus is the European Union member state whose house price index has grown the least relative to 2015 levels (6.4% in June 2022 versus a 45% increase for the euro area). This reflects, in part, the difficulties experienced by the domestic banking sector which restrict the credit supply. The authorities have implemented several macroprudential measures to limit financial stability risks including loan-to-value and debt service to income limits as well as capital buffers for other systemically important institutions.

Overview of Scope's qualitative assessments for Cyprus's *Financial Stability Risks*

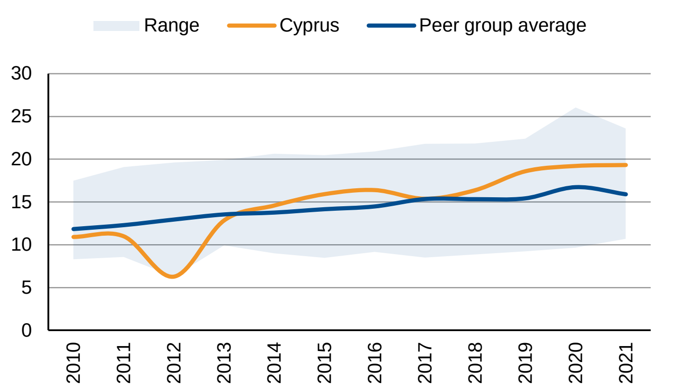
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Banking sector performance	Weak	-1/3	Poor asset quality and profitability pressures continue to weigh on banking sector performance but are improving
	Banking sector oversight	Neutral	0	Effective oversight; recently reinforced AML/CFT and NPL resolution frameworks
	Financial imbalances	Weak	-1/3	Elevated private indebtedness and financial fragility of households pose risks

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

ESG Risks

- **Environment:** Cyprus is particularly vulnerable to the adverse effects of climate change due to its position as a small Mediterranean island state. Cyprus' emissions reduction has lagged that of other EU states with a 4.1% decrease since 2005, below the EU-wide reduction of 19% over the same period. The country's National Energy and Climate plan sets emission reduction targets of 21% compared to 2005. Climate plans include a long-term strategy for building renovation, projects aimed at developing a natural gas system, the rollout of a renewable energy roadmap with the aim of reaching a 22.9% share by 2030, investments to encourage a shift towards green mobility and the introduction of a carbon tax. Planned policies are insufficient to meet Cyprus' climate goals on a stand-alone basis however, with the country relying on flexibilities under the Effort Sharing Regulation to meet its binding targets.

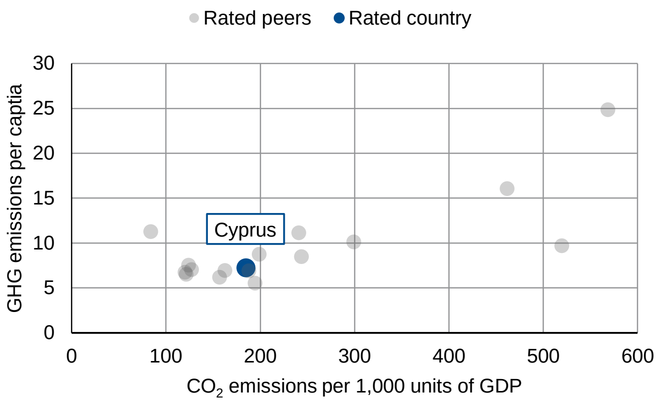
- **Social:** Cyprus benefits from favourable demographics and performs relatively well in terms of poverty, income inequality and health outcomes. Cyprus has posted one of the strongest improvements among EU countries regarding the share of people at risk of poverty or social exclusion over 2015-20 (-7.6pps). Cyprus performs poorly in terms of education outcomes, with its PISA scores ranking consistently among the lowest EU performers despite spending more on education than other EU countries (5.9% of GDP versus a 5.0% EU average) while youth unemployment remains high. Reforms under Cyprus' recovery and resilience plan should support social outcomes, but the cost-of-living crisis risks reversing gains in poverty reduction.

- **Governance:** Cyprus scores better than peers on the World Bank's Worldwide Governance Indicators but underperforms the EU average. The president, Níkos Anastasiádis, was re-elected in 2018 for another 5-year term although with continued minority control over parliament following legislative elections in 2021. Geopolitical risks persist on the island, with a division of the country between Greek and Turkish speaking communities. Negotiations over the reunification of the country have been deadlocked since talks broke down in April 2021 but unofficial dialogue remains open. Tensions between Cyprus, Greece, the EU and Turkey over competing claims to hydrocarbon reserves persist and have intensified.

Overview of Scope's qualitative assessments for Cyprus's *ESG Risks*

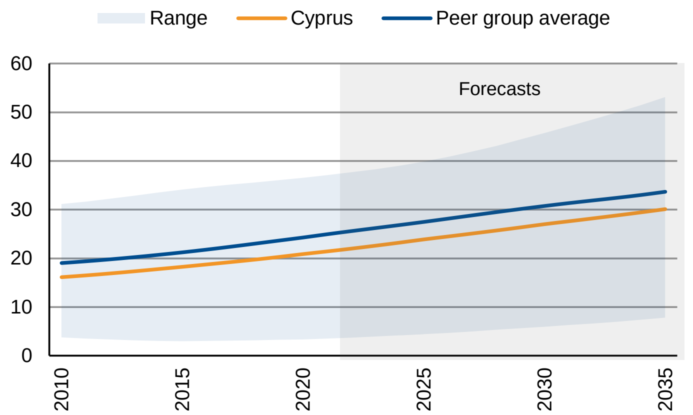
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental factors	Weak	-1/3	Elevated transition and resource risks; high mitigation costs due to geographical constraints and service-based economy
	Social factors	Neutral	0	Weak youth employment dynamics, gender equality and education outcomes; improving poverty and income inequality
	Governance factors	Weak	-1/3	Lingering geopolitical tensions and limited progress on reunification talks

Emissions per GDP and per capita, $mtCO_2e$



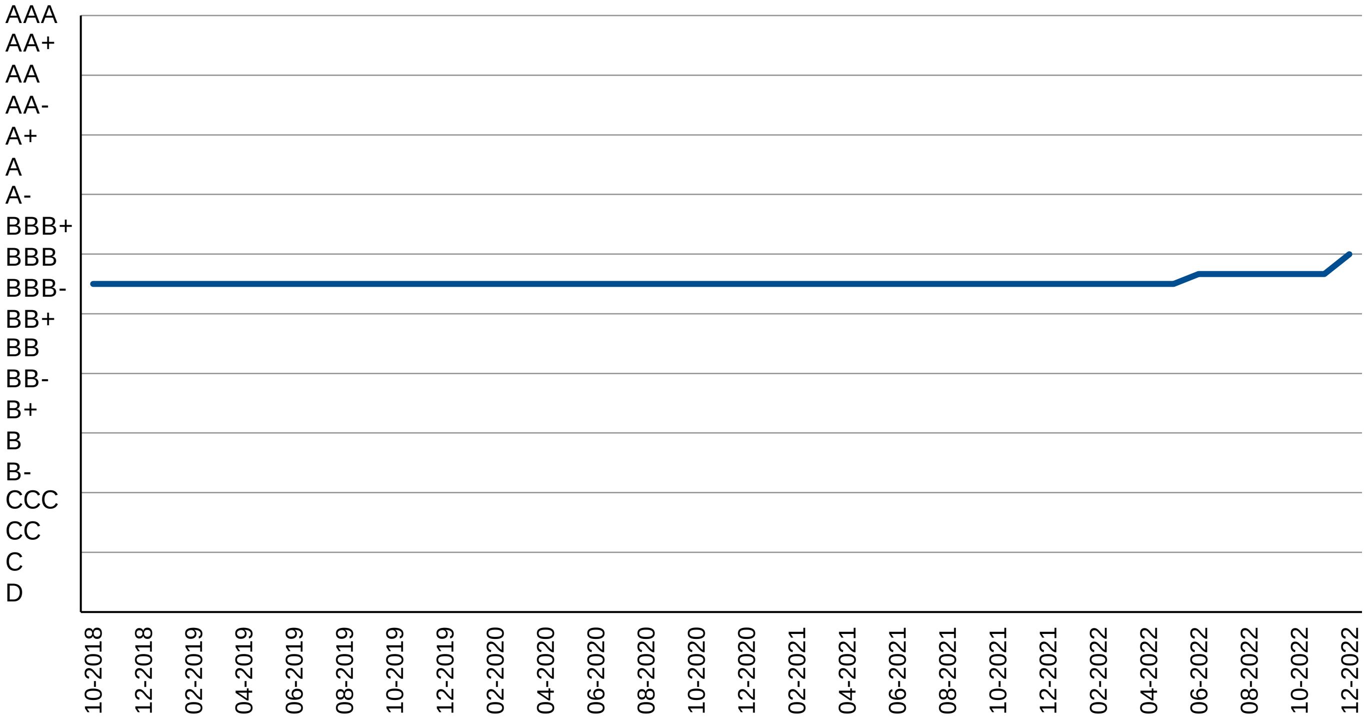
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Bulgaria
China
Croatia
Hungary
Italy
Latvia
Poland
Portugal
Slovakia
Spain

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD '000s**	IMF	26,746	29,547	29,412	27,784	30,957
	Nominal GDP, USD bn	IMF	22.9	25.5	25.8	24.7	27.7
	Real growth, %	IMF	5.9	5.7	5.3	-5.0	5.6
	CPI inflation, %	IMF	0.7	0.8	0.6	-1.1	2.2
	Unemployment rate, %	WB	11.1	8.4	7.1	7.6	6.1
Public Finance	**Public debt, % of GDP**	IMF	92.9	98.4	91.1	115.0	103.6
	Interest payment, % of revenue	IMF	6.1	5.7	5.3	5.1	4.1
	Primary balance, % of GDP	IMF	4.3	-1.3	3.4	-3.8	0.1
External Economic	**Current account balance, % of GDP**	IMF	-5.1	-4.0	-5.7	-10.1	-7.2
	Total reserves, months of imports	IMF	0.2	0.2	0.3	0.4	0.5
	NIIP, % of GDP	IMF	-144.6	-121.7	-116.6	-146.5	-115.5
Financial Stability	**NPL ratio, % of total loans**	IMF	31.4	19.5	17.1	15.0	9.0
	Tier 1 ratio, % of RWA	IMF	16.3	14.6	17.1	18.3	19.0
	Credit to private sector, % of GDP	WB	192.4	136.6	108.5	110.2	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	224.9	208.4	198.2	184.9	183.8
	Income share of bottom 50%, %	WID	19.5	19.0	19.2	19.2	19.2
	Labour-force participation rate, %	WB	72.8	74.1	74.8	-	-
	Old-age dependency ratio, %	UN	19.2	19.7	20.3	20.9	21.4
	Composite governance indicators*	WB	0.9	0.8	0.8	0.7	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 9 December 2022	99.5

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

10 avenue de Messine
F-75008 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30 31 58 14

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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