Republic of Cyprus
Rating Report

SCOPE BBB- POSITIVE OUTLOOK

Credit strengths

- Strong growth potential
- Solid fiscal consolidation prospects and improved debt profile
- Structural reform momentum

Credit challenges

- Small and externally dependent 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 record of fiscal consolidation characterised by consistent fiscal surpluses, overachieving fiscal targets, and a steadily decline in public indebtedness pre-Covid. Renewed commitment to fiscal discipline and a robust growth outlook underpin a return to pre-crisis debt levels within the forecast horizon.

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. The government's reform agenda as part of its National Reform and Recovery and Resilience plans should raise potential growth and address long-standing challenges.

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 scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	a+		-1/3	
Public Finance Risk		25%	aa		0	
External Economic Risk		10%	c		-3/3	
Financial Stability Risk		10%	a+		-2/3	BBB-
ESG Risk	Environmental Risk	5%	bbb+		-1/3	
	Social Risk	5%	aa		0	
	Governance Risk	10%	bbb		-1/3	
Overall outcome		**bbb+**		**+1**	**-3**	

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. In with our methodology, movements between indicative ratings are not immediate but are executed after analyst review of CVS results. The rating committee approved an implied CVS rating of 'bbb+'. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Positive Outlook reflects Scope's view that risks to the ratings are tilted to the upside.

Positive rating-change drivers

- Sustained strengthening of the banking sector
- Post-crisis fiscal performance improves, leading to a material decline in public debt stock
- Potential growth is raised sustainably

Negative rating-change drivers

- Medium-term growth prospects deteriorate substantially
- Fiscal outcomes are weaker than anticipated
- Banking sector fragilities re-emerge

Ratings and Outlook

Foreign currency

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

Local currency

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

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Bloomberg: RESP SCOP

Domestic Economic Risks

- **Growth outlook:** The economy was able to recover strongly from the Covid-19 crisis following relaxation of containment measures. Real GDP reached its pre-crisis levels as early as Q3 2021 and grew by 5.5 in 2021, well above previous estimates. The escalation of war in Ukraine will impact Cyprus's economic outlook mainly via direct trade in tourism and professional services with Russia and through the indirect effects of rising inflation and slower growth in euro area trading partners.

  The recent geopolitical crisis has slowed down the country's recovery and weakened the short-term economic outlook: we expect growth to slow substantially from 5.5% in 2021 to around 2% in 2022, before rising again thereafter and average around 2.7% over 2023-26. Strong medium-term growth will be supported by a normalisation of private consumption and investment, recovery in external demand and the country's strong growth potential estimated at 2.5%. Importantly, the government's national Recovery and Resilience Plan (RRP) and associated investments and structural reforms will be critical for underpinning longer-term growth and addressing structural economic bottlenecks.

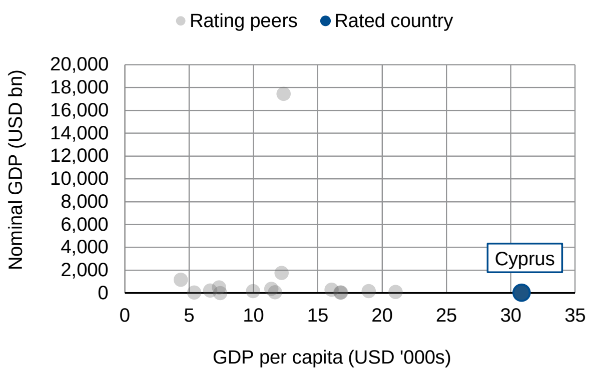
- **Inflation and monetary policy**: HICP inflation turned positive in March 2021, after eleven consecutive months of negative rates, and has since picked up substantially averaging 6.5% in the six months to May 2022, although remaining below the EU average of 7.0% despite Cyprus' import dependence for key commodities. The ECB has maintained exceptionally accommodative monetary policy over recent years but we expect at least 75bps of rate increases (as regards the deposit rate) starting July 2022 to 0.25% by year end before 1.25% (end-2023) after conclusion of the Asset Purchase Programme by July.

- **Labour markets**: Unemployment peaked at 9% in May 2021 and has since dropped to 5.4% as of April 2022, the lowest level since 2009. Underutilisation of labour in tourism-related sectors persists, but the flexibility of Cypriot labour market and the supportive fiscal measures contributed to the normalization of labour conditions. The government's strategy of developing new emerging sectors and reducing reliance on tourism, construction and real estate will require a reallocation of labour and addressing the country's skills gaps.

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

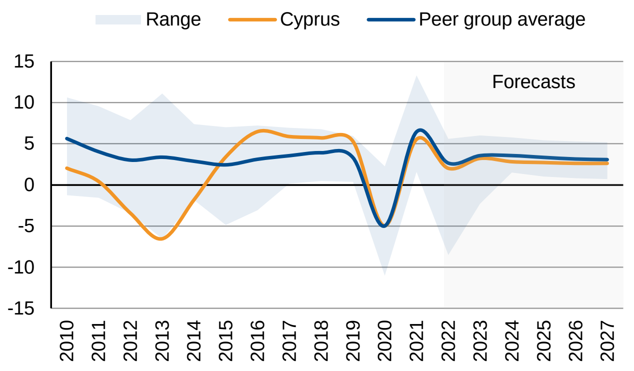
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Neutral	0	Strong growth potential supported by improving labour markets, foreign investment and reform; structural economic pressure due to war in Ukraine
	Monetary policy framework	Neutral	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 thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

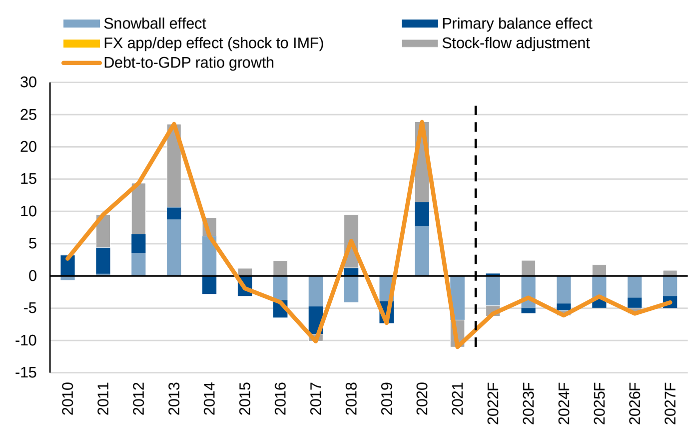
Public Finance Risks

- **Fiscal outlook**: The countercyclical fiscal policies of the Cypriot government in response to the Covid-crisis led to a substantial deterioration in the country's fiscal fundamentals. The budget deficit reached 5.8% of GDP, underpinned by large Covid-19 economic support measures. In 2021, budget performance improved better than expected to 1.7% of GDP thanks to cyclical improvements in revenue, the gradual withdrawal of Covid-19 support measures and lower than expected current spending. The government's medium-term budgetary strategy aims at maintaining fiscal support for the economy near-term, in line with the RRP, whilst maintaining fiscal sustainability and reducing public debt in a sustainable manner longer-term. We expect the budgetary position to improve gradually in coming years with a return to budget surpluses by 2024 and reach a 1% of GDP headline surplus for 2027. Risks to the fiscal outlook stem from the potential crystallization of past and newly created contingent liabilities.
- **Debt trajectory:** The combined impact of a marked deterioration in fiscal performance and the sharp contraction in GDP pushed the public debt-to-GDP ratio to an all-time high 115% in 2020, from 91% the year before. This increase also reflects a substantial increase in Cyprus's cash buffer which stood at 15% of GDP at the end of 2020. Net debt recorded a more moderate increase of 11bps of GDP. A significant improvement in budgetary performance, strong growth and the government's decision to reduce cash buffer will lead to substantial reductions in the debt-to-GDP ratio. We expect public debt to return to pre-pandemic levels by 2024 and reach 75% of GDP by 2027, one of the strongest reductions among EU countries.
- **Debt profile and market access:** Cyprus benefits from a favourable debt profile supported by its pro-active debt management strategy. As of year-end 2021, Cypriot public debt has a low share of short-term debt (1%), no foreign currency exposures, limited interest rate risks (69% 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 2.9% on 7 June 2022, versus 0.7% at the beginning of the year.

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

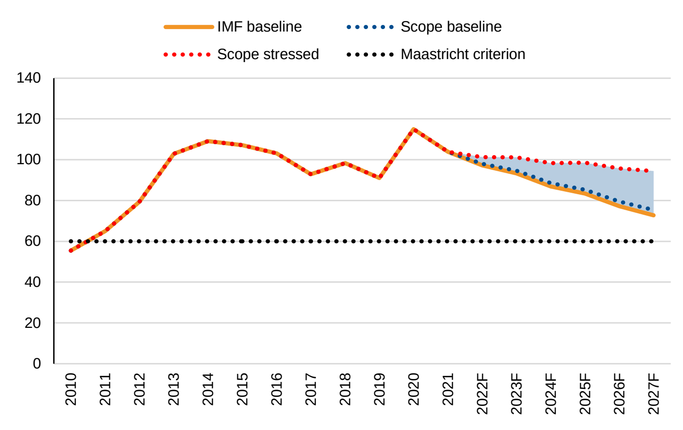
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Neutral	0	Good record of effective fiscal consolidation and overperforming fiscal targets
	Debt sustainability	Neutral	0	Elevated public debt; sharp increase in indebtedness due to Covid-19 crisis; medium term debt trajectory is steadily declining
	Debt profile and market access	Neutral	0	Declining interest payment burden, rising average maturity and improving investor base

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

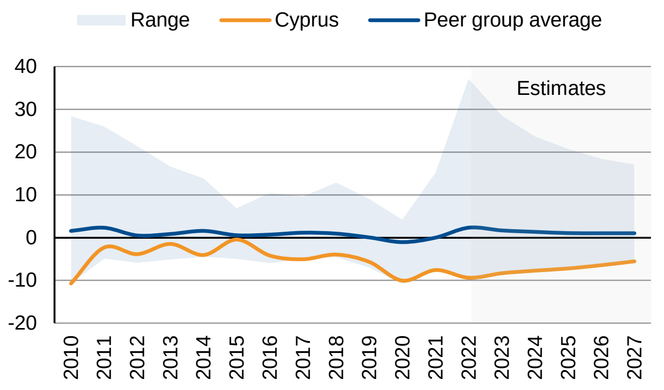
External Economic Risks

- **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. The current account deficit widened substantially to -10.1% of GDP in 2020 due to the Covid-19 pandemic, but it then narrowed to -7.2% of GDP in 2021 thanks to an improved surplus in services and a lower deficit of secondary income. The prevalence of Special Purpose Entities (SPEs) leads to significant distortions in its external statistics, with limited ties to the real economy. The current account balance adjusted for the impact of SPEs stood at -9.7% of GDP and -8.6% of GDP in 2020 and 2021 respectively. We expect the current account balance to gradually improve in coming years as external demand recovers albeit with some headwinds as terms of trade deteriorate.
- **External position:** Cyprus's external position is weak. The net international investment position was very negative at -123% of GDP at year-end 2021 (-43% of GDP adjusted for the impact of SPEs) which remains a source of vulnerability and warrants monitoring. Cyprus' external debt is high, at 822% of GDP at year-end 2021 (291% of GDP adjusted for the impact of SPEs) but has declined substantially in recent years, falling from the peak of 1259% 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*

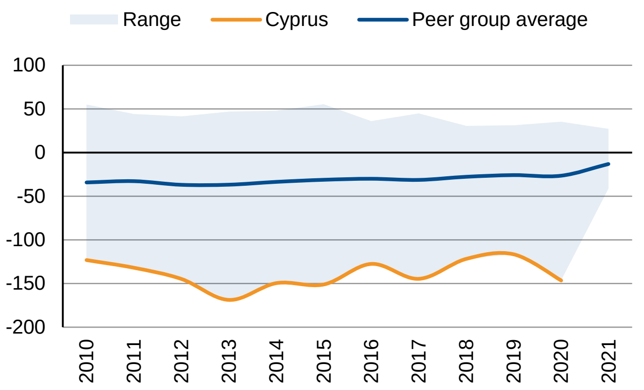
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
c	Current account resilience	Weak	-1/3	Consistent current account deficits with exports concentrated in a few key sectors
	External debt structure	Weak	-1/3	Large external debtor position and high external financing needs exacerbated by current account deficits
	Resilience to short-term shocks	Neutral	0	External imbalances are mitigated by euro area membership

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

Financial Stability Risks

- **Banking sector:** The Cypriot banking sector has weathered the Covid-19 crisis well with credit institutions showing stronger capitalisation levels, improved asset quality and comfortable liquidity positions. Capital positions remained strong with a Tier 1 ratio of 18.9% in September 2021, broadly unchanged since year-end 2019, and the liquidity coverage ratio was at a comfortable 312% at year-end 2021. The NPL ratio (excluding exposures to central banks and credit institutions) remains relatively high, though it decreased to around 11% in December 2021 from 18% in 2020. The country faces bottlenecks in NPE resolution due to inefficiencies in the legal system, some debtors' limited ability to pay and strategic default behaviour. Banks' exposure to the Russia-Ukraine conflict is limited, with only RCB Bank stopping its retail operations in March 2022 amid its strong ties with Russia and western sanctions.

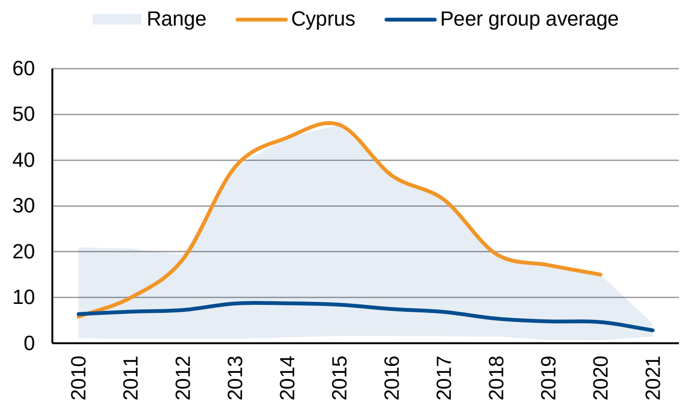
  Private debt: Private sector debt remains a weakness as more than 80% of bank loans are to highly leveraged households and SMEs. Household debt, at 91% of GDP in 2020, is the fourth highest in the EU after Denmark, the Netherlands, and Sweden. Similarly, consolidated nonfinancial corporate debt levels, although declining, remain high at 169% of GDP as of 2020, well above the EU average (71% of GDP). Particular attention should be paid to the household sector given its high levels of financial fragility. Cyprus is among the European countries whose household sector is the most vulnerable to unexpected shocks with 44.6% of households reporting their inability to meet an unexpected, required expense, according to EU Statistics on Income and Living Conditions survey data.

- **Financial imbalances:** Risks in the real estate sector are limited for now given broad stability in residential prices in recent years. Cyprus is the EU member state whose house price index has grown the least relative to 2015 levels (3.9% in December 2021 versus a euro area average increase of 38%). This reflects, in part, the difficulties experienced by the domestic banking sector which restrict the credit supply. Public 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*

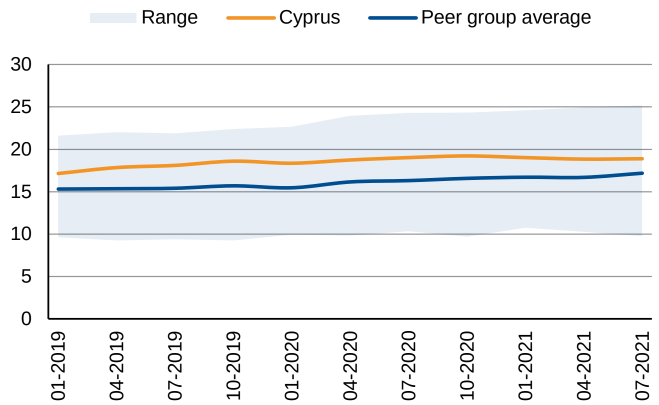
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Banking sector performance	Weak	-1/3	Poor asset quality and profitability pressures weigh on banking sector performance
	Banking sector oversight	Neutral	0	Effective oversight; recently reinforced AML/CFT and NPL resolution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

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

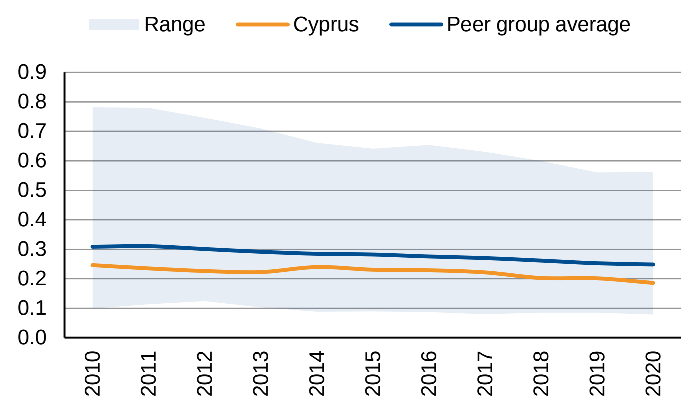
ESG Risks

- **Environment:** Cyprus is particularly vulnerable to the adverse effects of climate change due to its position as a small Mediterranean island state. Even though it accounts for just 0.26% of total GHG emissions in the EU, its economy is among the most carbon intensive in terms of CO² emissions per euro while 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, in line with the 24% target under the Effort Sharing Regulation when available flexibilities are taken into account. 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.
- **Social**: Cyprus benefits from favourable demographics and performs relatively well in terms of poverty and income inequality relative to peers, both of which are on an improving trajectory. Cyprus has posted one of the strongest improvements among EU countries regarding the share of people at risk of poverty or social exclusion over the last five years (-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 (5.4% of GDP versus a 4.7% EU average) while youth unemployment remains high.
- **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. 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*

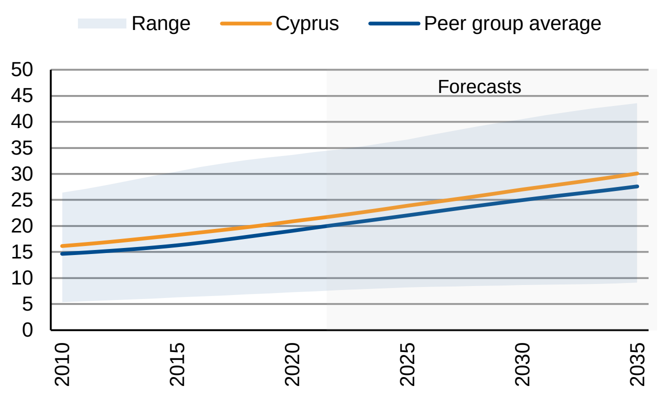
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental risks	Weak	-1/3	Elevated transition and resource risks; high mitigation costs due to geographical constraints and service-based economy
	Social risks	Neutral	0	Weak youth employment dynamics, gender equality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

CO2 emissions per GDP, mtCO2e



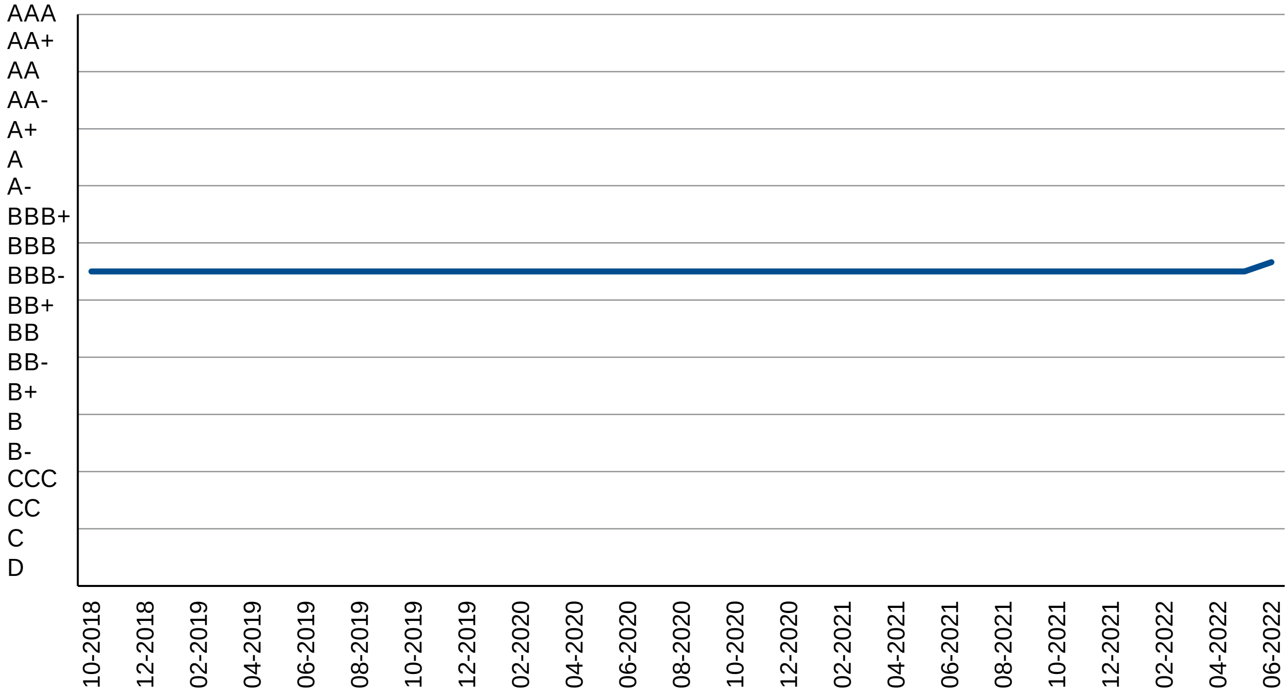
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



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.

Peer group*
Bulgaria
China
Croatia
Cyprus
Hungary
Slovakia

*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 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	24.7	26.7	29.5	29.4	27.8	30.8	30.7	33.0
Nominal GDP, USD bn	20.9	22.9	25.5	25.8	24.7	27.6	27.7	30.1
Real growth, %[1]	6.5	5.9	5.7	5.3	-5.0	5.5	2.0	3.2
CPI inflation, %	-1.4	0.5	1.4	0.3	-0.6	2.4	5.3	2.3
Unemployment rate, %[1]	13.0	11.1	8.4	7.1	7.6	7.5	7.1	6.5
Public Finance Risk								
Public debt, % of GDP[1]	103.1	92.9	98.4	91.1	115.0	103.6	97.6	94.3
Interest payment, % of government revenue	7.0	6.4	6.0	5.6	5.4	4.3	4.1	3.4
Primary balance, % of GDP[1]	2.9	4.4	-1.3	3.5	-3.6	0.2	0.0	0.8
External Economic Risk								
Current account balance, % of GDP	-4.2	-5.1	-4.0	-5.7	-10.1	-7.2	-9.4	-8.3
Total reserves, months of imports	0.3	0.2	0.2	0.3	0.4	-	-	-
NIIP, % of GDP	-133.8	-136.1	-125.6	-116.1	-136.2	-118.0	-	-
Financial Stability Risk								
NPL ratio, % of total loans	36.7	31.4	19.5	17.1	15.0	-	-	-
Tier 1 ratio, % of risk-weighted assets	16.4	15.4	16.4	18.6	19.2	18.9	-	-
Credit to private sector, % of GDP	217.6	192.4	136.6	108.5	110.6	-	-	-
ESG Risk								
CO_2 per EUR 1,000 of GDP, $mtCO_2e$	229.2	222.0	202.9	201.8	186.3	-	-	-
Income quintile share ratio (S80/S20), x	5.0	4.8	4.9	4.7	-	-	-	-
Labour-force participation rate, %	72.2	72.8	74.1	74.8	-	-	-	-
Old-age dependency ratio, %	18.7	19.2	19.7	20.3	20.9	21.4	22.0	22.6
Composite governance indicator[2]	0.9	0.9	0.8	0.8	0.7	-	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, National sources, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 20 June 2022	84.5

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