Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF CYPRUS	Assigned Ratings/Outlook: **BBB /stable**	Type: Monitoring, Unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	25-11-2016 10-02-2023 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating Action

Neuss, 10 February 2023

Creditreform Rating has raised its unsolicited long-term sovereign rating on the Republic of Cyprus to "BBB" from "BBB-". Creditreform Rating has also raised Cyprus' unsolicited ratings for foreign and local currency senior unsecured long-term debt to "BBB" from "BBB-". The outlook is stable.

The rating upgrade on the Republic of Cyprus reflects

(i) strong growth that was only temporarily interrupted by the pandemic and has hitherto shown broad resilience to the repercussions of the Russian war against Ukraine, translating into robust increases in Cyprus' per capita income levels;

(ii) our expectation of solid economic growth over the medium term that is likely to be aided by Cyprus' tourism industry as well as by structural reform initiatives and EU financing coming on the back of NextGenerationEU; and

(iii) the sovereign's strong fiscal performance and sound debt management, which have put its public debt ratio on a downward path that should be sustained over the medium term, accompanied by ongoing progress of the Cypriot banking sector in reducing its stock of non-performing loans (NPLs).

Key Rating Drivers

1. Robust economic growth trend, resulting in markedly rising GDP per capita, which we expect to move upwards going forward; following strong expansion in 2022, real GDP growth should ease considerably this year, mirroring weaker external demand, the adverse effects implied by the war in Ukraine and increasing interest rate levels, but should be supported by public investment and consumption as well as by resilient tourism activity

2. Expectation of ongoing solid growth over the medium term, buttressed by a thriving tourism industry and expanding ICT services, ongoing recovery in labor market conditions, and facilitated by the Recovery and Resilience Plan (RRP) along with related investment and reform initiatives aiming to address long-standing weaknesses; Cypriot economy should continue display a moderate level of diversification from a European perspective, and private sector debt remains relatively high

3. Despite visible efforts in terms of structural reforms, the sovereign continues to exhibit room to enhance its generally strong institutional set-up – in particular regarding government efficiency, rule of law and control of corruption, as reflected by Worldwide Governance Indicators; we expect authorities to make further headway in light of RRP reforms; moreover, Cyprus remains a strong beneficiary of being an EU/EMU member
4. Public finances have continued to brighten given the strong economic rebound in 2021 and 2022; although the outlook for Cyprus' fiscal metrics is ultimately subject to very high uncertainty linked to the development of the geopolitical situation, we believe that its public debt ratio will decline significantly over the medium term, mainly due to expected solid nominal GDP growth rates and sustained headline surpluses supported by the sovereign's prudent use of its fiscal space
5. Fiscal risks continue to be mitigated by low, albeit rising, refinancing costs, with debt affordability assumed to remain high; financing risks should remain low, reflecting ample cash buffers and sound debt management, which has led to a favorable debt profile; risks to fiscal sustainability mainly pertain to the National Health System (NHS) and the stock of NPLs, which despite progress remains high from a European angle
6. External vulnerabilities remain pronounced, as illustrated by the very high and negative net international investment position (NIIP); to be sure, special purpose entities (SPEs) do not have close links to the real economy, but account for a considerable share of the NIIP; we expect the NIIP to improve gradually over the medium term, in tandem with the current account, which was deeply in negative territory after a marked deterioration in 2022 and should remain very high this year

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The Republic of Cyprus' creditworthiness is backed by its robust macroeconomic performance profile and characterized by a very strong GDP growth trend. The latter was subject to some heightened volatility during extraordinary events related to the outbreak of the Covid-19 pandemic, as well as to the Russian military aggression against Ukraine more recently. That said, the Cypriot economy proved to be comparatively resilient, which resulted in significantly increasing per capita income levels. Cyprus' tourism industry remains its pivotal economic pillar, leaving it relatively vulnerable to shocks, although ICT services and pharmaceuticals have become more important more recently. Whilst labor market conditions continue to improve, private sector indebtedness remains comparatively high, and structural bottlenecks to its business environment remain in place, possibly weighing on medium-term growth performance. RRP-related initiatives address longer-standing challenges, in our view paving the way for higher underlying growth.

Following the relatively moderate pandemic-related decline in its real GDP (2020: -4.4%), Cyprus' economy resumed its strong growth trend in 2021. Driven by domestic demand as well as net

[1] This rating update takes into account information available until 03 February 2023.

external trade, total output jumped by 6.6%, with national account figures being revised upwards in 2020/21 since our last review. Reinvigorated exports expanded by 13.6%, partly thanks to the nascent recovery of tourism and export-oriented services, lifting net exports' growth contribution to 3.6 p.p. in 2021 (Eurostat). At the same time, sound management of the vaccination campaign allowed for eased refinement measures, propelling growth in household spending (+4.5%), which contributed 2.8 p.p. to real GDP growth in 2021.

Hence, Cyprus' economy expanded at a significantly faster pace than the euro area (EA) overall, which grew by 5.3% and averaged 1.0% p.a. in 2017-21, as compared to a strong 3.8% p.a. in Cyprus. As a corollary, Cypriot per capita income rose vividly over the last years. According to IMF estimates, GDP p.c. leapt by approx. 26% to USD 45,065 (PPP terms, current prices) between 2016 and 2021, before rising further to an estimated USD 49,504 in 2022, which corresponds to roughly 92% of the weighted EU average.

Despite significant crosscurrents in 2022, namely the Russian invasion of Ukraine and related adverse reverberations, the robust growth momentum was largely sustained up to the third quarter of last year. Drawing on latest available data, Cyprus' economy continued to grow dynamically, featuring quarterly growth of 1.7% and 0.3% q-o-q in Q1 and Q2-22 (swda), respectively, mainly due to growth in household spending and fixed investment. In the third quarter of 2022, real GDP expanded by 1.3% q-o-q, one of the strongest growth rates in Europe, largely driven by net external trade.

With a view to 2022 as a whole, we expect Cypriot real GDP growth to come in at a robust 5.5%. We believe that economic growth is set to decelerate significantly as of Q4-22 and throughout the first half of this year. Economic headwinds from weakening external demand, the adverse effects entailed by the war in Ukraine and rising interest rate levels implied by the tightening monetary policy stance will make themselves increasingly felt, presumably weighing on domestic demand and net exports alike. However, we think that a recession will be avoided, projecting real GDP growth to ease to 2.0% in 2023, before edging up to 2.6% in 2024. In this regard, we assume that adverse effects from the Russian invasion will fade from the second half of 2023, acknowledging the high degree of uncertainty related to the future development of the Russian war against Ukraine and the respective economic fallout.

Cyprus' tourism industry is set to be one of the key drivers of economic growth in the near term. To be sure, external demand for tourism services should suffer somewhat, with inflationary pressures also eating into real disposable incomes abroad and raising fuel costs. Notwithstanding, we anticipate that tourism will remain supportive of economic growth as illustrated by last year's developments, which were characterized by a rapidly recovering tourism industry despite geopolitical tensions. Irrespective of adverse inflationary effects and the tremendous decline in Russian tourists, tourist arrivals increased by 65% to roughly 3.2mn in 2021-22, around 80% of the level recorded in 2019. The sharp drop in the number of Russian tourists (-91%), which account for approx. 20% (avg. 2010-19) of overall arrivals in Cyprus, was largely offset by other, mainly European markets, in particular the UK (+210%), Israel (+238%), Germany (+107%), Poland (+65%), and Sweden (+180%). A full recovery of the tourism industry should be achieved by 2024 at the latest.

Overall, we pencil in a moderately positive growth contribution from net external trade this year and next. While ICT services, transport, as well as financial and business services should aid export growth as well, export growth should outpace import growth, partly due to weakening domestic demand.

In this vein, we expect fixed investment to contract this year, before gradually picking up beyond 2023. High frequency indicators such as industry sentiment and new orders bode ill for a notable expansion in machinery investment in the near term, whilst industrial production has been showing signs of weakness, having fallen by roughly 4.2% between April and November 2022 (Eurostat). Construction investment should continue to be curbed by rising prices of construction materials (Jan-Dec 2022: +17.2% y-o-y). Building permits (Jan-Oct 2022: -5.9 y-o-y) also cast a dim light on prospects for fixed investment in construction.

More generally, uncertainty should prompt companies to postpone investment decisions. In addition, investment activity is likely to be curbed by rising financing costs, reflecting turning tides in the global monetary policy stance. As illustrated by the January 2023 bank lending survey, in Q4-22 Cypriot banks have tightened credit standards for loans to enterprises and expected a more limited credit supply for Q1-23.

While the decline in gross fixed capital formation is likely to be buffered by large multi-year infrastructure projects started before the outbreak of the pandemic, growth will be aided by the ongoing RRP implementation. On the one hand, the RRP entails ramped-up public spending. Judging by the Draft Budgetary Plan 2023 (DBP23), presented by the Ministry of Finance (MoF) last October, public fixed investment will be increased by 3.0% this year. Also, the RRP is set to crowd in private investments tied to the green and digital transition.

Household spending growth should in turn soften markedly and remain relatively moderate in 2023/24. Last year, private consumption showed unabated growth up to the third quarter of 2022, reflecting pent-up demand, government support and a drawdown on household savings. Adverse effects are poised to take hold, as signaled by persistently downbeat consumer sentiment.

As opposed to its EU peers, Cyprus is not dependent on gas (2020; 0%), as its energy mix is mainly dominated by oil and petroleum products, accounting for approx. 86% in 2021 (EU: 34%), implying lower risk in terms of energy dependence on Russia. However, this stark dependence on oil entails a high sensitivity of consumer price inflation to oil price developments, as illustrated by price movements over the past two years. Going forward, we expect still high HICP inflation (2023e: 3.5%, 2022: 8.1%) to weigh on households' purchasing power, in particular in 2023, although the negative impact should subside, reflecting improvements in energy markets as well as base effects. HICP inflation has retreated to 6.8% y-o-y in Jan-23 (flash estimate data) since jolting to a multi-year high in Jul-22 (10.6%),

At the same time, authorities have implemented support measures to cushion the repercussions of rising prices, some of which will remain in place in 2023 (see below). Moreover, the government implemented a statutory minimum wage, which entered into force as of the beginning of this year. More generally, we see household spending buttressed by continued wage and employment growth.

Whilst average monthly earnings have increased vividly since Q4-21, posting high quarterly growth rates throughout 2022, we note that the labor market has remained robust so far, despite the recent pick-up in the unemployment rate. Slowing economic activity has thus begun to show up in monthly readings of the unemployment rate, which amounted to 7.5% in Nov-22 (EA: 6.5%, Eurostat, sa), up from 6.6% a year before and 6.1% in Jan-22. We nevertheless expect the annual average to remain broadly unchanged this year. Meanwhile, employment should continue to expand, but shift into a lower gear, after posting growth rates of at least 1.6% y-o-y since Q2-21 (Q3-22: 2.7%, EA: 1.7%). Labor participation has continued to trend upwards, standing at a new high of 78.7% in Q3-22, well above the euro area average of 74.6%.

Looking forward, growth performance should thus fall short of the growth rates witnessed in the years 2015-2019, but we believe that Cyprus will continue to show solid growth over the medium term. The implementation of Cyprus' RRP via significantly stepped-up spending and the adoption of structural reform measures will be a key support to economic activity over the medium term.

As elaborated during our last review, Cyprus is eligible to receive approx. EUR 1.2bn under the Recovery and Resilience Facility, of which EUR 1.0bn or 4.2% of 2021 GDP will be allocated in grants over 2021-26. After EUR 157mn had been disbursed in pre-financing in September 2021, Cyprus received EUR 85mn in December 2022 following the European Commission's (EC) positive assessment of Cyprus performance on the 14 milestones associated with this first installment (also see below).

In our opinion, the RRP's impact on Cyprus' economy goes beyond substantial financial support coming on the back of EU funding, since the government is incentivized to implement key policies addressing long-standing structural bottlenecks which hinder higher underlying growth. Latest EC estimates put Cyprus' potential growth at 2.8% and 2.6% in 2023 and 2024, respectively, well above the euro area average (1.1% and 1.3%). According to the EC, full and timely implementation of reforms and investments should lift Cyprus' GDP by 1.8% by 2026. The University of Cyprus arrives at a markedly more favorable estimate (approx. 7% by 2026).

In addition to its primary objective to foster the green and digital transition, the government aims to implement a plethora of reform initiatives geared towards structural challenges. The RRP and the National Reform Program 2022, which builds on the RRP, inter alia include measures to enhance the soundness of the banking sector, improve the efficiency of public administration, advance capacities in health and long-term care, tackle labor market challenges related to education and skills, and to strengthen the competitiveness and productivity growth of the economy.

Indeed, Cyprus' business environment continues to offer significant room to improve, among others regarding contract enforcement, which is hampered by weaknesses in terms of its judicial quality and efficiency (see below), and construction permits. Furthermore, timely and efficient debt collection and payment delays, as well as skills shortages in the labor market, represent further challenges as recently pointed out in the EC's SME Performance Review.

Another weakness relates to digitalization, as highlighted by the 2022 EC's Digital Economy and Society Index, in which Cyprus is ranked 20th among the 27 EU members. While Cyprus is attested to have made palpable progress across the board and clearly appears to be converging towards the EU average, basic digital skills are far from sufficient and the coverage of very high capacity networks has significant catching-up potential.

Meanwhile, the latest edition of the European Innovation Scoreboard pays testament to the notable efforts to raise underlying growth. Thus, in 2022, the EC classified Cyprus as a strong innovator which is increasing its performance at a much higher rate than the EU overall. That said, longer-standing weaknesses remain in place, first and foremost related to government support for business R&D and very low R&D expenditure more generally. Despite rapidly rising outlays on R&D, which rose from 0.54% to 0.87% of GDP in 2017-21, Cyprus' R&D intensity lies well below the EU average (2.26% of GDP).

While still awaiting the relaunch of the World Bank's Doing Business assessment envisaged for Q3-23, Cyprus was ranked at 40 out of 63 economies in the 2022 IMD World Competitiveness Yearbook (2021: rank 33), placing the country in the lower half among the EU member states.

Still, we do not see clear signs of weakening competitiveness of the Cypriot economy. As illustrated by AMECO data, real unit labor costs are estimated to have edged down by 3.7% in 2021-22, and to have decreased by 2.5% since 2017, as compared to a modest decline by 0.2% in 2017-22 in the euro area overall. By the same token, latest data on Cyprus' global export market share also gives no reason for concern. To the contrary, its share in global services exports expanded further, and was up to 0.35% in 2021 (2020: 0.34%, 2017: 0.25%), whereas the total share comprising goods and services remained stable at 0.09% in 2022 vs. 2021.

On the other hand, we have to flag still high private sector debt levels as a factor possibly constraining medium-term growth. We note that non-financial corporations' debt has followed a firm downward trend over recent years and declined from 175.8% of GDP in Q2-21 to 157.5% of GDP in Q2-22 (QFA and NA data). Although standing at its lowest level since the beginning of 2007, Cyprus' NFC debt is the second-highest in the EU27, acknowledging a considerable bias stemming from SPE's activity. In light of increasing energy and commodity prices and, in turn, diminishing profit margins, credit risks in the corporate sector could increase. Still, insolvencies have hitherto remained at low levels, having fallen by roughly 40% y-o-y in Q2-22 and Q3-22, respectively (Eurostat). Likewise, households may increasingly face difficulties in servicing their debt, cutting household spending, against the backdrop of household debt equating to 126.0% of disposable income in Q4-21 (Q4-20: 128.5%, ECB data), one of the highest readings in the EU.

Institutional Structure

The sovereign's ratings continue to reflect its generally strong institutional conditions, which are further buttressed by the sizable benefits entailed by Cyprus' membership in the EU/EMU. The sovereign's institutional framework is still characterized by some gaps in terms of good governance as compared to the euro area overall, as underscored by the recent vintage of Worldwide Governance Indicators (WGIs). Despite progressing reforms, Cyprus particularly has ample room to improve the quality and efficiency of its judicial system and needs to address deficiencies as regards anti-money laundering (AML) and counter-terrorist financing (CTF) measures. That said, the sovereign, in our view, has an exemplary track record in terms of reform ownership and the implementation of reforms as recommended by international organizations. To this end, we expect a full and timely implementation of reforms under RRP, which addresses key challenges and inefficiencies in the public sector. We vigilantly monitor developments in the Mediterranean Sea, as geopolitical tensions have increased in light of recent natural gas discoveries and the imminent Turkish presidential election. We do not assume any major changes to the sovereign's political priorities from the presidential election held in early February.

Drawing on the latest vintage of the World Bank's WGIs, which relate to the reference year 2021 and serve us as a key metric for determining institutional quality, we observe a partly deteriorating picture, whilst Cyprus still displays considerable gaps across the board as compared to the respective euro area averages (median).

Concerning the perceived freedom of speech and free media (voice and accountability), Cyprus slipped by three places to the relative rank 55 out of 209 economies, thus standing well below the euro area average (rank 29). In the same vein, we note a weaker relative ranking when it comes to the perceived quality of policy formulation and implementation (government effectiveness), with Cyprus falling from rank 48 to rank 54 (EA: rank 39). By contrast, although also comparing rather unfavorably to the respective median rank of the euro area (rank 34), the WGI rule of law improved to relative rank 58 as compared to the preceding year (rank 64). As regards the perception of the extent to which public power is exercised for private gain (control of corruption), the sovereign's ranking remains unchanged at a relatively high rank 73 (EA: rank 45).

Indeed, the latest report on MONEYVAL's assessment of the sovereign's AML and CTF measures (Nov-22) concludes that Cyprus has embarked on a raft of measures aimed at deficiencies identified by MONEYVAL in the course of its fifth evaluation round, but several shortcomings remain. While some deficiencies are deemed moderate, e.g. related to the not yet fully implemented measures to assess TF risk and the lack of an action plan to tackle risks associated with virtual assets services providers, the report particularly highlights the absence of powers to intercept the content of communication as regards ML/TF investigation. Moreover, we note that the National Anti-corruption Authority, which was set up in February 2022, still had not been fully operational by the end of last year. The newly established authority has reportedly found difficulties in hiring specialists for its staff.

At the same time, the sovereign's judicial system continues to face severe shortcomings in terms of efficiency and quality. As corroborated by the recent EU Justice Scoreboard published last year, the time needed to resolve cases remains very long, and the average length of the judicial review very high, whereas the number of pending cases is very large as compared to its peers from the EU. Additionally, the quality is hampered by significant challenges as regards digitalization and adequate financial resources.

The RRP contains vital structural reforms geared towards tackling challenges in the public sector, such as improving intra-governmental coordination, speeding up legislation of key reforms to foster efficiency in public administration and advancing the efficiency and digitalization of the judicial system. Key deliverables under the RRP in the near term include the introduction of action plans for addressing NPLs and the promotion of e-skills, the implementation of an e-justice system and the adoption of a revised Social Insurance Law.

We are confident that the government will largely achieve a timely and efficient implementation of the national RRP, translating into notably improving institutional conditions over the medium to longer term, based on the sovereign's track record of demonstrated reform ownership over the last decade, the performance-based and reform-contingent RRF payments, and recent headway being made in terms of reform initiatives.

This is illustrated by the adoption of a draft legislation on splitting the Supreme Court, the envisaged implementation of new rules of civil procedure, interim measures to advance digital solutions, and the laws enacted on whistleblower protection and on transparency in lobbying, as also noted by the EC in its latest Rule of Law Report. Also, as was elaborated above, Cyprus was allocated a first RRF installment after achieving the associated 14 milestones, pertaining to reforms in the electricity market, financial sector, and in public administration.

While the RRP is also key to facilitating the green transformation of Cyprus' economy, we think that the sovereign faces formidable challenges on its road to becoming carbon-neutral by 2050 and increasingly diversifying its energy mix in light of heavy dependence on oil and petroleum products. Cyprus' greenhouse gas (GHG) emissions are among the highest in the EU and remain stubbornly high, though having declined more recently. According to latest Eurostat data, Cyprus' GHG emissions amounted to 10.3 tons per capita in 2020, down from 11.3 tons p.c. a year before, but standing roughly at the same level as in 2013 (10.1 tons p.c.). As a point of reference, the EU's GHG emissions have followed a firm downward trend over the last decade, posting at 7.5 tons p.c. in 2020.

In this vein, Cyprus is deemed as further belonging to those countries which have yet to catch up in terms of eco-innovation, as recently pointed out by the EC in its 2022 assessment. Although Cyprus has improved and has tended to close the gap somewhat towards the EU average, it falls short of EU benchmarks in sustainable resource management and societal behavior, with waste recycling being a particular weakness.

What is more, Cyprus noticeably lags the respective EU average (2021: 37.5%) regarding the overall share of energy from renewable sources in gross electricity consumption, though having more than doubled its share from 6.7% to 14.8% in 2012-21. The share of renewables in its energy mix came to just 11.2% in 2021 (EU: 17.2%).

Regarding energy diversification, we note that the Eastern Mediterranean south of Cyprus has seen some of the largest natural gas discoveries in the past decade. Last year, a consortium of Eni and Total discovered further natural gas reserves in this area. While the discoveries might be viewed as an important step towards mitigating European exposure to Russian natural gas supplies more generally, these also fueled geopolitical tensions with neighboring Türkiye, with Turkish rhetoric escalating lately.

Fiscal Sustainability

After the pandemic had led to a new historic peak in the sovereign's public debt ratio, public finances have improved significantly on the back of a strong economic rebound and recourse to large cash buffers over the past two years, translating into narrowing primary deficits and sharply falling debt-to-GDP. While geopolitical events related to the Russia-Ukraine war pose significant downside risks and create massive uncertainty, we project the public debt ratio to decline substantially over the medium term, reflecting our expectation of solid nominal GDP growth and persistent headline surpluses. Fiscal risks stemming from the sustainability of the NHS and the banking sector remain in place, as reflected by still relatively high, albeit decreasing, NPLs and stage 2 loans. Prudent debt management and a benign debt structure continue to be important risk mitigants, with a favorable maturity profile and still affordable debt. Refinancing conditions are about to cloud going forward in the context of monetary tightening.

In light of the economic rebound, higher tax receipts and social security contributions, as well as the gradual withdrawal of crisis-related containment and support measures, Cyprus' fiscal deficit narrowed from a pandemic-related 5.8% of GDP in 2020 to 1.7% of GDP in 2021, well below the reading of the euro area as a whole (-5.1% of GDP).

Fiscal metrics continued to improve significantly last year, as robust economic growth accompanied by rapidly rising prices resulted in vividly increasing tax receipts, while social security contributions benefited from strong employment growth. At the same time, Covid-19 measures were gradually withdrawn and support measures to cushion the effects of soaring energy prices were comparatively moderate from a European angle. Measures to limit the economic fallout of rising energy prices are estimated to have a budgetary impact of approx. 0.6% of GDP in 2022 (DBP23).

Going forward, we expect prudent fiscal policy-making coupled with gradually strengthening economic growth and subsiding headwinds, particularly regarding inflationary pressures, to translate into sustained headline surpluses. For 2023, we pencil in a headline surplus of 1.2% of GDP coming on the heels of a budget surplus of 1.5% of GDP in 2022. We still have to emphasize that uncertainty around these estimates remains high in view of dynamically evolving and uncertain geopolitical developments.

Preliminary Cystat fiscal accounts data for the first eleven months in 2022 hint at strong fiscal performance last year, as general government accounts recorded a surplus of 1.7% of GDP over that period. Between January and November 2022, total general government revenue expanded by 12.7% y-o-y as taxes and social security contributions rose sharply. Whilst net VAT receipts increased by 19.8% on the year, revenue from income and wealth taxes also evolved dynamically (+20.0% y-o-y). By contrast, general government outlays only rose by 3.8% y-o-y, largely driven by the public wage bill and social benefits, which edged up by 5.2% and 10.0% y-o-y, respectively. At the same time, subsidies (-81.8%) and interest payments (-8.1%) declined considerably.

Despite our expectation of significantly slowing economic activity this year, the headline surplus should come in only slightly below last year's outturn. Government expenditure will likely decline as measured against GDP in 2023, thanks to further falling interest costs as well as diminishing subsidies in the context of waning pandemic-related and energy support measures. Regarding the latter, most of the energy measures expired in 2022, whereas e.g. reduced excise duties on petrol and subsidies for childcare have been extended, and the list of vulnerable energy consumers was enlarged. Expenditure will be buttressed by growing social benefits, an increasing public wage bill, and rising public fixed investment. On the revenue side, we anticipate growth in tax receipts to decelerate, but continue growing, while ongoing, albeit slower employment growth should remain supportive of social security contributions.

Following the surge in public debt in the context of the Covid-19 pandemic, the subsequent economic recovery has led to a substantial reduction of Cyprus' debt-to-GDP ratio, from 113.5% in 2020 to 101.0% in 2021. Looking at latest available data, the public debt ratio continued its downward trajectory, falling sharply to 91.6% of GDP in Q3-22, with vibrant economic growth, a sizeable primary surplus and the utilization of ample cash buffers representing the main drivers. Looking forward and building on the assumptions of strong nominal growth and persistent primary surpluses, we forecast general government debt to fall further from 88.4% of GDP in 2022 – below its pre-pandemic level (2019: 90.4%) – to 81.9% of GDP in 2023, and continue on its downward trajectory over the medium term.

Fiscal risks mainly relate to contingent liability risks. To be sure, public guarantees are relatively moderate. The MoF estimates public guarantees to drop to 5.0% of GDP in 2022 and decrease further in the current year (DBP23). On the other hand, NPLs and stage 2 loans point to still prevalent risks entailed by the banking sector's asset quality, which could deteriorate again in light of rising interest rates, still stretched private sector balance sheets and the macroeconomic backdrop.

Financial soundness metrics of the relatively large Cypriot banking sector (Q2-22: 256.5% of GDP, ECB data) have improved. Headway has been made in terms of capitalization, as the CET1-ratio went up from 16.8% in Q3-21 to 17.3% in Q3-22 (EU: 15.0%, EBA data). The banking sector exhibits ample liquidity in case of sudden liquidity outflows, as suggested by the loan-deposit-ratio, which posts at 50.7% (Q3-22, CBC data).

In addition, Cyprus' banks were able to significantly improve their asset quality, as the NPL ratio more than halved from 6.9% to 3.2% in the year to Q3-22 (EBA data), but remained relatively high by European standards (EU average: 1.8%). Based on Central Bank of Cyprus data, NPLs (NPLs over total gross loans and advances) stood at 10.5% in Oct-22, down from 15.3% a year before, although we note that in the year 2022 the nominal decline of NPLs by EUR 0.27bn to EUR 2.7bn was comparatively moderate. Against this background, we have to highlight that the total share of stage 2 loans remained among the higher ones in the EU, coming to 14.1% as of Q3-22 (EU: 9.5%), while having dropped by 2.0 p.p. compared to Q3-21 (EBA data).

With foreclosures suspension having been extended multiple times since the outbreak of the pandemic and expiring only recently (31-Jan-23), we will monitor further decisions by the authorities, as a renewed suspension may hamper more notable progress in the reduction of NPLs going forward. Additionally, it may also further delay a timely dissolution of the residential property portfolio of KEDIPES, the state-owned asset management company. Tying in with that, we will follow closely progress on the implementation of the envisaged mortgage-to-rent (MTR) scheme. While the EC's decision concerning the approval of the scheme is currently pending, the MTR is likely to foster further NPL reduction.

In any case, we assess persistently prudent debt management and the resulting benign debt profile as an important factor in mitigating risks related to the sovereign's fiscal sustainability. The sovereign faces no FX risks, and short-term debt accounts for only 0.7% of general government debt (Jul-22, PDMO). Floating rate debt makes up for a high 29% (EA average ~9%), but mainly due to ESM loans. In this context, it is worth mentioning that official loans stand for approx. 35% of Cyprus' public debt. The first repayment (EUR 0.35bn) regarding the ESM loan principal of EUR 6.3bn will be due at the end of 2025. Moreover, Cyprus displays a relatively high average weighted maturity, amounting to 7.7 years as of Nov-22, up from 7.5 years as of Nov-21 (ECB data).

Debt sustainability is further strengthened by a declining interest-to-revenue ratio, which suggests an increasing debt affordability. Interest outlays accounted for 4.4% of total revenue in 2021 and we expect it to have fallen well below 4% by the end of 2022. Thanks to historically still very low interest rates and lower-yielding issuances replacing debt with higher interest rates, interest-to-revenue is likely to evolve favorably in the near term. That said, increasingly tight monetary policy has fed through to upward trending bond yields. Posting at 4.2% (20-Jan-23, weekly quote), the yield on 10-year government bonds leapt by 338 basis points (bp) within roughly one year, whereas the Bund spread has risen by 223bp (weekly data). At the same time, Cyprus boasts abundant cash reserves, with the liquidity buffer sufficient to cover more than 3.5 times the financial obligations over the next 9 months (371%, Dec-22).

Following the first monetary policy meeting in 2023, the ECB raised its policy rates by another 50bp, envisaging a further 50bp hike for March. We expect key interest rates to be lifted by an additional 100bp by the end of the current year. Furthermore, the ECB specified its plan to gradually wind down the APP from March 2023 onwards, with an initial monthly portfolio reduction of EUR 15bn until June 2023. As regards bond purchases under the PEPP and PSPP, cumulative net purchases amounted to EUR 2.5bn (as of Nov-22, PEPP) and EUR 4.5bn (as of Dec-22, PSPP), respectively, tantamount to 29.2% of Cyprus' Nov-22 consolidated general government debt (ECB and CYSTAT data). Maturing securities under the PEPP will be reinvested until the end of next year at least.

Foreign Exposure

The sovereign remains subject to vulnerabilities linked to its status as a small open economy and a pronounced external debtor, recalling that the highly negative NIIP remains somewhat distorted by SPE activities with limited links to the domestic real economy. Despite ongoing strong recovery of tourism following the pandemic, the current account deficit remains more pronounced than prior to the corona crisis, dragged down by a worsening goods balance due to the very high sensitivity of Cyprus to global oil price movements. Assuming moderating energy prices from recent high levels and some adaptations in the energy sector, we expect a gradual improvement of the current account balance and the NIIP over the medium term.

Concluding 2021 with a deficit of 6.8% of GDP, Cyprus' current account balance benefited from rebounding tourism following the most acute pandemic phase, lifting the surplus in the service balance. At the same time, the deficit in goods trade in terms of GDP narrowed somewhat compared to the preceding year. More recently, over Q1-Q3 2022, however, soaring energy prices in the face of Russia's attack on Ukraine had the current account deficit swell again amid a worsening energy balance, in particular due to higher costs of importing oil, exacerbating the goods trade deficit.

An increasingly positive net position regarding trade in services, with the main drivers being the travel and ICT categories, did not make up for this. As of Q3-22, the deficit in the current account balance thus ballooned to 9.5% of GDP, measured as a four-quarter moving sum. Looking ahead, expected decreases in energy prices should help to lower the current account deficit, acknowledging a considerable level of uncertainty around these developments. Whilst tourism should remain a key pillar to net service exports, exports of IT services, transport, financial and business services may be affected to some extent by the sanctions against Russia, but generally the data reflect diversification to markets other than Russia. In particular, net exports of ICT services are expected to remain a main support alongside tourism.

Cyprus' NIIP, meanwhile, improved by 16.8 p.p. to -117.8% of GDP in 2020-21, decreasing further to -107.1% of GDP as of Q3-22. According to the Central Bank of Cyprus, excluding the effect of SPE-related movements in the position, the remaining balance improved to -38.8% of GDP in the first nine months of 2022, positively affected by the recovering GDP, but nevertheless signaling less pronounced external risks than the headline NIIP at face value.

The reduced negative NIIP also masks a larger net liability position as regards foreign direct investment, which would be in line with authorities' declared strategy to attract foreign investment, including through the creation of a Business Facilitation Unit. Despite persisting uncertainty over ultimate effects on the NIIP of the war and related sanctions against Russia, which as individual country accounts for the largest assets and liabilities stocks vis-a-vis Cyprus, we tentatively expect a further gradual improvement over the medium-to-longer term.

Rating Outlook and Sensitivity

Our rating outlook on the Republic of Cyprus is stable. We consider current downside risks to the macroeconomic performance and vulnerabilities regarding the external exposure as being balanced by a robust recovery of tourism and diversified service exports, the positive medium-term outlook due to a presumably ongoing RRP-implementation and a prospectively further improving situation regarding the banking sector alongside improving fiscal metrics.

We could lower the sovereign's credit ratings or outlook if economic prospects deteriorate drastically, possibly on the back of a substantially worsening geopolitical situation and associated price movements, postponing an expected acceleration of economic activity and significantly dragging down the medium-term growth outlook. Such a scenario could also include deteriorating asset quality in the banking sector and materializing contingent liabilities. Partly related to this, we could also contemplate a negative rating action if, contrary to our belief, the sovereign failed to bring its public debt ratio on a firm downward path over the medium term.

By contrast, we could consider raising the sovereign's credit rating or outlook if economic growth outperforms our expectations, with structural improvements through the RRP swiftly translating into a markedly more favorable medium-term growth outlook. Clearly receding risks to external trade and the external position emanating from the war in Ukraine and the associated sanctions, giving way to a sustainably more positive current account balance, would also add positively. Moreover, a further decline of NPLs and a faster-than-expected downward trend of the debt ratio could also represent triggers to a positive rating action.

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Ratings*

Long-term sovereign rating	BBB /stable
Foreign currency senior unsecured long-term debt	BBB /stable
Local currency senior unsecured long-term debt	BBB /stable

*) Unsolicited

ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

ESG Factor Box

Environ-mental Quality	Ecological Risks	Ressource Management	Education	Health	Demo-graphics
Labor	Equality	Technology & Infrastructure	Saftey & Security	**Judicial system**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liber-ties/ Political Participation**	Market Access	**Business Environ-ment**	Data Transparency

Environment	**Social**	**Governance**	**Highly significant**	**Significant**	**Less significant**	**Hardly significant**

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the assessment of a economy's competitive stance by e.g. the World Bank, the World Economic Forum, the European Commission, and IMD Business School add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022e	2023e
Macroeconomic Performance							
Real GDP growth	5.7	5.6	5.5	-4.4	6.6	5.5	2.0
GDP per capita (PPP, USD)	38,516	41,227	43,593	41,348	45,065	49,504	52,057
Credit to the private sector/GDP	208.8	142.3	113.8	115.2	97.3	n/a	n/a
Unemployment rate	11.1	8.4	7.1	7.6	7.5	n/a	n/a
Real unit labor costs (index 2015=100)	98.0	98.2	99.5	103.6	99.3	95.6	97.7
World Competitiveness Ranking (rank)	37	41	41	30	33	40	n/a
Life expectancy at birth (years)	82.2	82.9	82.3	82.4	81.8	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	0.9	0.7	0.8	0.6	0.6	n/a	n/a
WGI Control of Corruption (score)	0.8	0.6	0.6	0.4	0.4	n/a	n/a
WGI Voice and Accountability (score)	1.1	1.0	1.0	0.9	0.9	n/a	n/a
WGI Government Effectiveness (score)	0.9	0.9	1.0	0.9	0.7	n/a	n/a
HICP inflation rate, y-o-y change	0.7	0.8	0.5	-1.1	2.3	8.1	3.5
GHG emissions (tons of CO2 equivalent p.c.)	11.6	11.4	11.3	10.3	n/a	n/a	n/a
Default history (years since default)	4	5	6	7	8	9	10
Fiscal Sustainability							
Fiscal balance/GDP	1.9	-3.6	1.3	-5.8	-1.7	1.5	1.2
General government gross debt/GDP	92.6	98.1	90.4	113.5	101.0	88.4	81.9
Interest/revenue	6.4	6.0	5.6	5.4	4.4	n/a	n/a
Debt/revenue	241.8	251.5	229.6	292.4	244.2	n/a	n/a
Total residual maturity of debt securities (years)	4.8	5.0	5.9	7.9	7.8	7.8	n/a
Foreign exposure							
Current account balance/GDP	-5.0	-4.0	-5.6	-10.1	-6.8	n/a	n/a
International reserves/imports	0.1	0.1	0.1	0.1	0.2	n/a	n/a
NIIP/GDP	-135.7	-125.2	-115.4	-134.5	-117.8	n/a	n/a
External debt/GDP	1021.4	891.7	824,3	801,8	699.5	n/a	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Cystat, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	25.11.2016	BB /stable
Monitoring	24.11.2017	BB /positive
Monitoring	26.10.2018	BB+ /positive
Monitoring	25.10.2019	BBB- /positive
Monitoring	24.04.2020	BBB- /stable
Monitoring	12.03.2021	BBB- /stable
Monitoring	11.03.2022	BBB- /stable
Monitoring	10.02.2023	BBB /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Ministry of Finance (MoF) and the Central Bank of Cyprus (CBC) participated in the credit rating process as they provided additional information and data, and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of MoF and CBC during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, IMD Business School, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, Central Bank of Cyprus, Republic of Cyprus - Ministry of Finance, Public Debt Management Office, Statistical Service of Cyprus (Cystat), Fiscal Council of Cyprus.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the

CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

Disclaimer

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