Creditreform Rating

Rating Update:

Creditreform Rating revises Cyprus' outlook to "stable", ratings affirmed at "BBB-"

Rating Action

Neuss, 24 April 2020

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

Reasons for the Outlook Revision

The outlook on the Republic of Cyprus has been revised from positive to stable, reflecting our expectation that

(i) economic developments will deteriorate substantially in the near term, also reflecting the weakening of the important tourism sector, which may take longer to recover in a scenario in which some restrictions to travel and gastronomy may remain in place for an extended period of time; related to that, an assumed labor market improvement in a phase of recovery may take longer than seen in the aftermath of the 2012/13 crisis experienced by the country; and

(ii) the improvement in the sovereign's public finances will be interrupted by a significant short-term rise in the public debt ratio from a still high level; while the ratio should resume trending downward over the medium term, fiscal risks have generally risen against the backdrop of remaining challenges such as high - albeit declining - NPE ratios in the banking sector, a high level of guarantees, and increased volatility in government bond yields.

High risks surrounding assumed economic recovery after steep transitory economic downturn

While the spread of the coronavirus and the measures taken to combat it substantially dampen our short-term outlook, it is hardly possible to predict the scope of the economic fallout, not least because the situation continues to evolve very dynamically. It goes without saying that the duration of the shock is also contingent on the development of effective medicines. Cypriot authorities have seized encompassing measures to limit the economic damage from this pandemic – which in a first instance include protection of employees and vulnerable groups, enhancing the health system and support to businesses.

Contributions from the ECB to mitigate the economic and financial distress span from a separate program of asset purchases (PEPP) with an envelope of EUR 750bn and additional net purchases of EUR 120bn to the existing asset purchase program, over enhanced liquidity provision to higher flexibility as regards accepting collateral and the treatment of rating downgrades.

We currently envisage a more or less V-shaped pattern as regards the economic development this year as a baseline scenario, with GDP declining by 5.3% this year, followed by increasing economic output to the tune of 5.8% in 2021. This expectation, which remains subject to extreme uncertainty, rests on the tentative assumption of a steep decline, especially in the second quarter, and a beginning economic recovery in the second half of the year amid a gradual easing of restrictions over the coming months. We cannot rule out sizeable revisions should such assumptions prove untenable as we get more information on developments concerning the pandemic and its economic repercussions.

Before the corona crisis unfolded, the economic outlook on the Cypriot economy seemed relatively robust, despite a likely moderation of real GDP growth compared to 2019. Household expenditure growth should have seen some slowdown, nevertheless being supported by a well-performing labor market, wage growth and low inflation. We now expect a decline in household spending in 2020 along with a deterioration on the labor market with inevitable layoffs, despite measures taken to retain staff and to facilitate the financial operation of enterprises. In such an environment, households' saving rate may also increase.

Construction investment, which accounts for the lion's share of gross fixed capital formation, appeared set to add to economic output this year, albeit less so than in the preceding year, partly due to finalized construction projects. Amid worsening news regarding the spread of the coronavirus and first steps to contain its negative effects, economic sentiment saw a steep decline in March, pointing to downward risks to investment. With more restrictions now in place to combat the virus, construction projects may be paused or at least slowed down, making declines in gross fixed capital formation this year more likely.

Adding to this and to a weaker outlook in the medium term are stricter requirements for citizenship via participation in investment schemes, which could put off potential investors to some extent. Apart from that, Brexit-related uncertainty, which had also been weighing on business sentiment more generally, should continue to pose a drag, as long as there is no breakthrough in negotiations over the future relationship between the UK and the EU. The UK is an important trading partner to Cyprus and home to a third of visiting tourists to the country. While we consider an extension of the transition period beyond 2020 as likely given the distraction caused by and the detrimental effects of the corona crisis, a 'hard Brexit' cannot be ruled out entirely, adding to risks for investment in the medium term.

Net exports appear set to act as a burden on GDP growth in 2020, bearing in mind that high dependence on tourism will pose major challenges. While presumably declining domestic demand and impaired supply chains should also lead to falling imports, we thus assume a steeper drop in exports. Brexit uncertainty, as mentioned above, was weighing on the outlook for tourism already, along with recovering tourism in competitor countries such as Turkey or Egypt. With airlines now widely grounded and a number of insolvencies likely to materialize in this sector as a consequence of the crisis, in addition to people's reluctance to travel as long as no vaccine to the coronavirus can be provided, at least the near-term outlook for tourism seems rather bleak, highlighting the need to monitor these developments carefully.

Recalling fiscal risks in view of expected transitory deterioration in public finances

Before the corona pandemic, Cyprus seemed well on course to achieve another sizeable general government surplus, with the government assuming a surplus to the tune of 2.7% of GDP in its DBP 2020. In light of the now expected sharp decline in real GDP growth, and the initial emergency package, the headline balance should turn into a deficit, which at present we estimate to be around 2% of GDP. We gather that initial budgetary measures taken by the Cypriot authorities could add up to about EUR 370m, in addition to tax measures amounting to EUR 304m and measures such as the suspension of a scheduled increase in contributions to the National Health System freeing up about EUR 147m, which would be largely budgetary neutral. Furthermore, the authorities mention guarantees of EUR 2bn for the provision of low interest loans to businesses and self-employed.

This estimate remains subject to a high degree of uncertainty, not least due to guarantees that might be called on, along with possible further support measures as deemed necessary. The downward trend in the government debt ratio should thus reverse temporarily, but presumably continue beyond 2020, aided by resuming GDP growth. Fiscally prudent behavior as seen over recent years should contribute to reining in downside risks to the fiscal outlook over the medium term.

In this context, we recall that the banking sector continues to display one of the highest NPE ratios in the EU, notwithstanding significant progress in reducing those since 2014, and that high private debt entails further vulnerabilities for the sector in the current delicate economic climate, arguably underscoring intensifying risks to fiscal sustainability in the medium term. Comparatively high guarantees as measured against GDP before the corona crisis are likely to become enhanced, as described above, and call for a further note of caution.

Given that financial markets remain susceptible to the high degree of economic uncertainty and the associated uncertainty as regards fiscal sustainability once the most acute phase of the pandemic has been overcome, debt-servicing cost dynamics will also have to be monitored, given that Cyprus' interest payments measured against revenue ranges among the highest in the EU. The ECB's swift monetary policy loosening, liquidity provision, and applied flexibility in terms of collateral and rating considerations certainly act as a cushion and will provide a benign environment for the time being. However, we note that 10y bond yields have recently risen to 2.16% (14-Apr-20), after hovering around 0.50% from mid-2019 to March 2020 and then climbing while displaying considerable volatility.

Reasons for the Rating Decision

Looking beyond the challenges and major uncertainties presented by the Covid-19 pandemic in Cyprus, we consider the sovereign's creditworthiness in terms of macroeconomic performance as generally strong, although this assessment has to be balanced against a comparatively moderate economic diversification and still high private indebtedness. Prospects for investment, and hence the opportunity to diversify the growth base in the medium term, therefore seem somewhat dampened.

Real economic growth remained far above growth rates recorded for the euro area as a whole in 2019, although slowing down markedly to 3.2% (2018: 4.1%), mainly on the back of a large negative contribution from inventories. Gross fixed capital investment virtually stagnated, partly due to plummeting transport investment, once more underscoring volatility linked to the activities of special purpose entities (shipping). Investment thus also failed to support GDP growth, despite strong but decreased growth in construction investment. Domestic demand was instead carried by private and public consumption growth, with private consumption expansion moderating only slightly to a 3% annual rate, still spurred by a well-performing labor market, associated wage increases, and low inflation. Public consumption soared by 11.3%, contributing more to GDP growth than net exports, which added 0.5 percentage points in a challenging international context that saw export growth diminishing to 2% and import growth slowing to 1.5%, constituting the slowest respective increases since the crisis year 2013.

The continued upswing on the labor market, reflected in an increase in employment by 3.1% and a slump in the unemployment rate by 1.3 percentage points to 7.1% - the lowest reading since 2010 – now looks set to experience a drastic reversal in light of the fallout from the pandemic, although we currently expect this to be a transitory phenomenon, subject to a high degree of uncertainty. In this context, we will monitor if labor market metrics can regain their previous strength more or less in tune with the economic performance, thereby testifying to the existence of reasonably flexible labor market structures.

Turning to what we perceive to be risk factors to the macroeconomic performance more generally, private debt ratios remain among the highest in the European Union, despite recent notable declines. Whilst NFC debt fell by roughly 20 p.p. to 167.4% of GDP in the year to Q4-19 (ECB data), household debt ranks among the highest in Europe, standing at 91.2% of GDP in Q3-19 (Q3-18: 97.7%, Eurostat non-consolidate financial balance sheet data). Risk-bearing capacities of the private sector thus appear limited and prospects for growth-broadening investment in the medium term subdued. An ongoing weak ranking by European standards regarding the World Bank’s Ease of Doing Business compilation adds to the latter conclusion, although we note that Cyprus has climbed three ranks to 54th out of 190 overall in the latest edition.

Tying in with concerns over medium-term growth prospects, the economy’s rather low level of diversification (services-to-industry ratio of 5.4, third-highest in the EU) and high exposure to tourism continue to represent sources of vulnerability, especially given potentially longer-lasting negative effects on tourism from the pandemic. Measured in terms of GVA, the share of the services sector amounted to 82.4% in Q4-19, with the category trade, transport, accommodation and food service activities - which also includes tourism - accounting for 25.1 percentage points alone. According to Eurostat data, employment in tourism industries accounts for roughly 20% of total employment in the business sector, the second highest reading in the EU (2017 data).

Cyprus’ favorable institutional framework, sound policy-making, and high degree of ownership as regards policy recommendations by the EU and IMF following the 2012/2013 crisis, continue to constitute positive elements concerning its credit rating. The latest vintage of the World Bank’s Worldwide Governance Indicators (WGI) attests to Cyprus’ consistently solid performance in terms of institutional quality, as its rankings remain roughly on par with respective medians for our A-rated universe, although failing to keep up with the respective medians for the euro area. To our understanding, the reunification debate has been stagnating recently, not yielding any major new progress. Tensions between Cyprus and Turkey following oil and gas drilling by Turkey along the Cypriot coast remain an issue, adding to geopolitical risks.

Fiscal sustainability remains a credit weakness, despite notably improved underlying fiscal metrics over the past few years owing to prudent policy-making. General government debt continues to be elevated, as is the level of guarantees, and notwithstanding headway in reducing banking sector NPE, these remain among the highest in the EU, posing risks to fiscal sustainability.

The positive development of the general government budget balance over the last few years, briefly reversed by the sale and winding-down process of Cyprus Cooperative Bank Ltd (CCB) in 2018, continued in 2019 with the surplus based on preliminary finance ministry data coming in at 2.7% of GDP, which would fall short of the 3.8% surplus envisaged in the DBP 2020 due to exceeding the expenditure target (39.4% of GDP, DBP20: 38.4%), partly due to higher intermediate consumption (5.2% of GDP). Drawing on Ministry of Finance data (which to our understanding do not include EU funds flow adjustments yet), we observe that strongly rising revenues, which increased by 11.7%, were buoyed by soaring social security contributions and direct tax revenue, reflecting still vivid economic activity. Meanwhile, total current expenditure rose by 12.8% amid a higher public wage bill (+10.1%).

Although on course to achieve a decline to 97.4% of GDP as envisaged in the government's DBP 2020 (Q3-19: 97.8%, Eurostat), thus continuing a downward trend temporarily reversed in 2018 due to the abovementioned one-off, Cyprus' public debt-to-GDP ratio remains elevated by European standards. State guarantees, which due to CCB's sale have gone up significantly but are expected to decline gradually, continue to pose risks to fiscal sustainability, as do comparatively high interest payments (5.8% of revenue in 2019). However, the latter should be mitigated by ongoing accommodative monetary policy and sound debt management. Having said this, risks stemming from the large banking sector (assets-to-GDP of 269.7% of GDP as of Q3-19, median of EU-28 at 176.8%) in view of a still high although diminishing NPE ratio (16.2% as of Q4-19, EBA data) persist.

As to Cyprus' foreign exposure, a highly negative net international investment position points to ongoing vulnerabilities as regards Cyprus' external position, although we observe further narrowing from -121.3% of GDP in 2018 to -116.0% of GDP in 2019. The current account deficit jumped from 4.4% to 6.7% of GDP in 2018-19, mainly driven by a larger deficit in the primary income balance and a lower surplus in services trade. Looking ahead, the challenging situation in the tourism sector due to the pandemic, and a likely setback to international trade, suggest significant widening of the current account deficit in the near term.

Rating Sensitivity

The outlook for the long-term credit ratings of the Republic of Cyprus is stable, as we expect the risk situation underlying the main factors affecting sovereign credit risk to remain fundamentally unchanged over the next twelve months. However, the assessment and interpretation of economic developments in the near future is much more challenging than under normal circumstances, as is the case for other indicators, given the current considerable uncertainty in the economy and financial markets, and the constantly evolving news flow surrounding Covid-19 and its impact.

Downward pressure on Cyprus's ratings or the related outlook could arise if the assumed transitory character of deteriorating public finances does not become reality, and the debt-to-GDP ratio remains elevated or continues to rise. This could be the case if contingent liabilities stemming from the banking sector and/or guarantees materialize. Adding to this risk could be an extended economic downturn if the detrimental effects of the pandemic are prolonged, or if renewed waves of stricter containment measures become necessary.

We could consider a positive rating action if medium-term growth comes in stronger than expected, possibly in connection with progress in terms of economic diversification, if NPE resolution is making substantial headway, if contingent liabilities are significantly reduced, and/or if we see the public debt ratio sustainably falling below prudential thresholds.

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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

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019e	2020e
Real GDP growth	-1.9	3.4	6.7	4.4	4.1	3.2	-5.3
GDP per capita (PPP, USD)	32,597	34,019	35,969	37,994	39,987	41,407	n.a.
HICP inflation rate, y-o-y change	-0.3	-1.5	-1.2	0.7	0.8	0.5	0.6
Default history (years since default)	1	2	3	4	5	6	7
Life expectancy at birth (years)	82.3	81.8	82.7	82.2	82.9	n.a.	n.a.
Fiscal balance/GDP	-8.7	-1.0	0.1	1.7	-4.4	2.7	-2.1
Current account balance/GDP	-4.1	-0.4	-4.2	-5.1	-4.4	-6.7	n.a.
External debt/GDP	1149.4	1262.8	1147.8	1074.5	990.9	935.6	n.a.

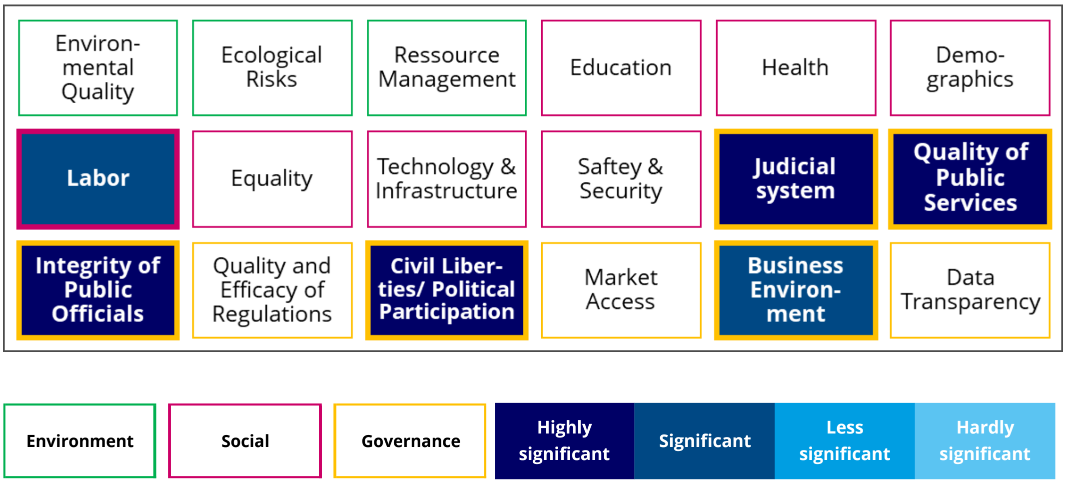
Source: International Monetary Fund, Eurostat, Ministry of Finance Cyprus, own estimates

ESG Factors

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



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 competitive stance of the sovereign such as the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating's considerations on macroeconomic performance of the sovereign, and we regard the ESG factor 'Labor' as significant to the credit rating or adjustments thereof.

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.

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

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.

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	NO
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 the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

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, Central Bank of Cyprus, Republic of Cyprus - Ministry of Finance, Public Debt Management Office, Statistical Service of Cyprus (Cystat).

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.

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