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 12-03-2021 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating Action

Neuss, 12 March 2021

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

Key Rating Drivers

1. Cyprus features a relatively wealthy economy and showed comparatively strong growth prior to the outbreak of Covid-19; we expect a consumption-led recovery, which should gradually gain strength from H2-21; a moderate degree of economic diversification and high exposure to tourism are factors dampening medium-term prospects, whereas Next Generation EU (NGEU) funds should help to direct investment towards broadening its economic base and thus foster medium-term growth; rather high level of private indebtedness by EU standards limits risk-bearing capacities
2. Solid institutional framework which is supported by EU/euro area membership especially in light of substantial EU-level response to the pandemic; we view the decision to ultimately abolish the controversial investor citizenship scheme as another case in point for our perception of a good responsiveness to country-specific recommendations by EU/IMF and a high degree of reform ownership
3. Following notable progress in fiscal consolidation, the Covid-19 crisis is causing a substantial, although presumably transitory, deterioration in fiscal metrics, lifting the already elevated public debt ratio to new highs; risks to fiscal sustainability stem from high and prospectively temporarily increasing NPEs, notwithstanding a marked downward trend and enhanced capital buffers over the last few years, as well as from comparatively high and increasing contingent liability risks; we believe that increasing debt affordability and sound debt management, as also evidenced by a high cash buffer and an improved debt profile, mitigate risks at this stage, along with ongoing favorable financing conditions
4. Despite improvements in the net international investment position (NIIP), we view the external position as a source of vulnerability, even when excluding SPEs; the sluggish pace of normalization in the tourism sector and some Brexit-related fallout could prevent a sustainable narrowing of the current account deficit for the time being

Reasons for the Rating Decision and Latest Developments

Creditreform Rating has affirmed the Republic of Cyprus' credit ratings, which rest on a solid macroeconomic performance profile which, however, leaves room for structural improvements, as well as on a favorable institutional framework benefiting from EU-level support to overcome the pandemic, while risks to fiscal sustainability and risks from external exposure continue to present credit weaknesses.

Macroeconomic Performance

In general, Cyprus' solid macroeconomic profile is underpinned by an impressive growth record and ongoing improvement in labor market metrics in the few years before the corona crisis, as well as by a relatively high level of wealth in terms of GDP per capita. The Covid-19 pandemic is causing severe damage to the country's important tourism industry, highlighting persistent vulnerabilities owing to a modest degree of diversification. Private indebtedness remains high, thus limiting risk-bearing capacities. Despite improving prospects on the back of an advancing vaccination process, which buttresses our assumption of a consumption-led recovery gradually gaining strength, uncertainty is still unusually high, also in light of virus mutations, thus casting some shadows on the otherwise benign medium-term growth outlook as transitioning towards a more diversified economic base remains a work in progress. While low productivity growth and the business environment present challenges, well-targeted NGEU funds, which should help to address vulnerabilities and may boost productivity, could enhance economic resilience.

Following strong annual economic growth averaging 4.6% over the period 2015-2019 (euro area: 1.9%), which bolstered Cyprus' outperformance against our A-rated universe in terms of GDP per capita (2020: USD 39,079 in PPP terms, IMF data), the Covid-19 pandemic took a heavy toll on the country's economic output. In 2020, real GDP declined by 5.1% (2019: +3.1%), according to preliminary data. Having said this, the outcome was less severe than the contraction registered for the euro area (EA) as a whole (-6.6%), pointing to effective and well-targeted measures by the government to limit the fallout from this health crisis. With initiatives supporting the health sector, businesses, and households, the government provided an estimated EUR 845mn last year (about 4.0% of 2020 GDP), including among others wage subsidies, grants to small businesses and self-employed, support for the tourism sector, leave allowance for parents and suspension of increases in social contributions, payment moratoria for loans, and interest subsidy schemes for business and housing loans. Most measures have been extended well into 2021 amid the second wave of infections.

After a rather mild contraction by comparison in the first quarter of last year, partly due to a relatively late implementation of the first lockdown, the Cypriot economy nosedived in Q2-20 (-13.1% q-o-q), but bounced back in Q3-20 (+8.9%) as restrictions were gradually eased. Despite a renewed infection wave in Q4-20 which led to re-introduced restrictions that became stricter in Jan-21 amid a temporary lockdown, real GDP rose by 1.4% q-o-q in the fourth quarter (-4.5% y-o-y), contrary to contractions registered in many other euro area members (EA: -0.7% q-o-q). Rebounding investment turned out to be the main growth driver (q-o-q) in the last quarter of 2020, with public consumption also contributing positively, whereas private consumption and exports saw small declines.

Looking at the GDP expenditure breakdown for 2020 as a whole, exports posted the steepest fall last year (-17.4% y-o-y, CyStat provisional data), driven by tumbling tourism and transport services, as travel bans were in place between 15 March and 8 June 2020, and only partly lifted thereafter. Tourist arrivals dropped by 84.1% in 2020 compared to 2019, resulting in revenue losses of 85.4%. With imports declining by 5.8%, the growth contribution of net exports was heavily negative, highlighting Cyprus' vulnerability in the context of the current pandemic due to its high exposure to tourism. Declines in private consumption (-3.9%) and gross fixed capital formation (-2.1%) appeared comparatively moderate, whereas government consumption proved to be a very supportive pillar for the second consecutive year, increasing by 13.0% (2019: 15.1%), also on the back of the implementation of the National Health System (NHS), which will continue in 2021.

The decline in private consumption has proved limited against the backdrop of a labor market development still robust when the novel coronavirus hit last year and in light of swift support by the government in the form of wage subsidization and the introduction of loan moratoria. Moreover, Cyprus was so far allocated EUR 479mn in loans via the EU-labor market assistance tool SURE. Having experienced a continuous recovery from 2014 until the outbreak of Covid-19 crisis, Cyprus' unemployment fell to 7.1% in 2019, its lowest level since 2010 and below the level of the euro area as a whole (2019: 7.5%), before the pandemic caused a deterioration last year. On a monthly basis, the unemployment rate climbed from 6.3% in Dec-19 to 7.3% in Dec-20 (EA: 8.3%), after spiking to 10.5% in August. Employment started to decline from Q1-20 on a quarterly basis, and contrary to the euro area overall, the number of jobs continued to fall in the second half of the year. The participation rate has remained broadly stable, at 76.0% in Q3-20 (EA: 73.2%).

Against this backdrop and in light of pent-up demand, we expect household spending to be the main growth driver going forward. Still, tourism may see a longer lasting adverse impact, implying the risk of renewed increase in unemployment that might hamper private consumption, potentially slowing the overall economic recovery. Consumer sentiment data suggests that private households remain rather pessimistic concerning unemployment in the coming twelve months.

Gross fixed capital formation should be constrained by subdued prospects for tourism-related investment, as long as there is no clear perspective of achievable herd immunity against Covid-19. We also think that vague prospects following the UK's departure from the EU, even in light of an existing agreement on post-Brexit goods trade, at present add to downside risks. In the past, UK citizens accounted for about a third of tourists visiting Cyprus, and demand for holiday homes may be dampened for the time being. Apart from that, abolition of the investor citizenship scheme (ICS) as of 1 November 2020 is likely to weigh on gross fixed capital formation going forward, presumably chiefly affecting construction investment. This being said, sizeable funds via NGEU, which to our understanding would amount to a maximum of EUR 968mn in grants and EUR 774mn in loans (2018 prices) over the period to 2026 offer some upside also for 2021, as they could start to be channeled into growth-enhancing capital formation. We await more detail on this from the national Recovery and Resilience Plan which will be submitted by April this year.

Despite a nascent recovery, export growth looks set to remain dampened by the suffering tourism industry as well as by the transport industry to some extent, and should take significantly longer to recover as compared to domestic demand. On a brighter note, prospects for international trade should improve somewhat under the new US administration. As imports are likely to recover strongly amid more vivid domestic demand, net exports should exert a neutral growth contribution. Meanwhile, we took note of a tourism deal between Cyprus, Greece, and Israel, which allows for unimpeded traveling on the basis of vaccination certificates. Whilst this agreement attests to the government's efforts to diversify its tourism base, it could also serve as a blueprint for further travel deals, implying some upside risks to the development of services exports.

Expectations for GDP growth in Q1-21 remain muted in view of a strict lockdown that was imposed in January, also mirrored in a strong decline in economic sentiment from Dec-20 to Jan-21. Real GDP might just stagnate or even decline somewhat on a q-o-q basis in Q1-21, but we expect an overall smaller negative impact on the economy as opposed to last spring as consumers and businesses have been adapting to the new situation. While measures are being gradually wound down from February, the outlook has begun to improve somewhat, along with progress made on the vaccination front. Roughly 9.7% of the population have received a first dose, the third-highest reading in the EU as of 9 March, flanked by ample testing capacities – with Cyprus also being well advanced in this respect (ECDC data). Nevertheless, uncertainty remains unusually high, especially over the new variants of the virus. Our base scenario remains an economic recovery from Q2-21, but interruptions or a delay in the vaccination campaign could lead to setbacks. We currently expect real GDP to come in at 3.5% this year. For 2022, given further vaccination progress and concerted efforts on the national and EU levels to revamp growth, we consider some acceleration to about 4.3% as likely.

Looking forward, our medium-term growth expectations are bolstered to some extent by the prospect of NGEU as well as the new Multiannual Financial Framework 2021-27, from which Cyprus could receive anther EUR 959mn (+35.2% compared to 2014-2020). To our understanding, total support from the EU would amount to more than EUR 2.7bn until 2029. Directing these funds partly towards enhancing the business environment and towards improving the digitization of its economy should be conducive to broadening the growth base and making economic development more resilient. According to a sensitivity analysis conducted by the Central Bank of Cyprus (CBC), which incorporates constant inflows from the NGEU funds, there could be a positive impact on the GDP growth rate of up to 0.3 p.p. per year until 2026.

With regard to the latest Digital Economy and Society Index (DESI, 2020), Cyprus was seen only in the 24th position among the 28 EU member states at the time, hinting at upward potential especially as far as connectivity and human capital is concerned. This may deliver part of the explanation as to why Cyprus' real productivity growth per person has been lagging behind, averaging 2.3% over the period 2010-19 against 4.3% in the euro area. However, potential growth is nevertheless estimated to exceed the level estimated for the euro area as a whole over the next years (1.7% and 1.8% in 2021/22 vs. 0.7% and 0.8% in the EA, AMECO).

To this end, we note that the government's strategic framework aims to increase the growth potential, to enhance competitiveness and foster sustainable economic growth. Diversification of the productive base and promotion of high value-adding sectors such as legal, financial, logistics and shipping services remain key objectives as well. We also gather that the government intends to front-load mature public investment projects and promote private investment through the utilization of the Recovery and Resilience Facility (RRF) and InvestEU. As mentioned above, we expect more detail to become available here over the coming months.

Notwithstanding significant deleveraging over recent years, private sector debt as a share of GDP remains comparatively high, also when excluding some distorting effects due to Special

Purpose Entities (SPEs), suggesting limited risk-bearing capacities. Debt of non-financial corporations (NFC) had dwindled to its lowest level since 2008, reaching approx. 170% of GDP in Q4-19, before edging up to 176% of GDP (Q3-20) in the wake of the corona crisis. Excluding SPEs, NFC debt came in at a still high 108% of GDP (CBC data). Similarly, household debt increased to roughly 93% of GDP in the third quarter of 2020, also among the highest readings in Europe, after having fallen to 89% of GDP by the end of 2019. Largely driven by loan moratoria, which have been extended to June 2021, the annual rate of change in the outstanding volume of private sector loans went up to 1.8% by Nov-20 (Dec-19: 0.2%, CBC data). Excluding SPEs, loans to NFCs have slightly exceeded the previous year's level in Nov-20 (+0.1%), while household loans grew by 3.0%, mainly due to housing loans which benefited from the abovementioned interest rate subsidization scheme. Bank lending surveys suggest that increasing loan demand from the private sector should remain in place going forward.

Institutional Structure

Our assessment of the sovereign's creditworthiness is supported by a generally strong institutional set-up. The small open economy draws significant benefits from its EU/EMU membership, as also underscored by the substantial monetary policy (ECB) and fiscal policy (EU) support to assist an economic recovery against the backdrop of the pandemic. Responsiveness in terms of commitment to and delivering on EU recommendations remains visible, and the sovereign demonstrates to our mind a good degree of ownership in this regard.

Turning to our preferred measure for institutional quality, the World Bank's Worldwide Governance Indicators (WGIs), we observe that Cyprus continued to lag behind the euro area median in the latest vintage, while remaining roughly in line with the median of our A-rated sovereigns. Apart from scope to improve when it comes to the perceived quality of policy formulation and implementation (WGI government effectiveness rank 45 out of 209 economies, EA median: 35), the gap to the euro area remains somewhat more pronounced with regard to the WGIs rule of law (rank 50 vs. EA median of 33) and control of corruption (rank 60 vs. EA median of 42). Concerning the latter, we note a persistent deterioration over the years, with the reference year 2019 marking the weakest assessment since the inception of the WGIs in 1996.

Having said this, last year's EU Rule of Law Report strikes a somewhat more constructive note with respect to the perception of Cyprus' effectiveness in combating and preventing corruption. At the same time, crucial legislation with regard to whistle-blower protection and lobbying is still pending, as is the establishment of an independent anti-corruption body. In a similar vein, we are aware of further steps taken to implement recommendations made in the Fourth Round Evaluation Report by the Council of Europe anti-corruption body GRECO. Cyprus has satisfactorily implemented seven of the sixteen recommendations contained in the report. Of the remaining recommendations, six have been partially implemented while three have not been implemented. We will continue to monitor developments as the sovereign is supposed to report back on these issues by 31 October.

We assess as positive that the government tackles structural deficiencies in the Cypriot justice system, reflected by a prolonged time needed to resolve cases and a relatively large backlog of pending cases (2020 EU Justice Scoreboard). Structural reforms are ongoing, in particular regarding the organization of courts and digitization to enhance the system's efficiency. The establishment of specialized courts, the possibility for more targeted training and initiatives to address the backlog of cases are among the steps that have been taken since 2019. On the other hand, a reform on implementing a Supreme Constitutional Court and a High Court seems to be stagnating. Furthermore, the government aims at reforming company law, in particular with respect to streamlining and simplifying procedures in the legislative framework on insolvency.

Following controversy over its ICS, which also involved the European Commission's launching of an infringement procedure against Cyprus in October 2020, the government decided to terminate the scheme as of 1 November 2020. We ultimately view this step taken by the authorities as an act demonstrating responsiveness to EU recommendations, while also suggesting a high degree of ownership.

The government appears to remain committed to its privatization plans, irrespective of the annulment of the Privatization Law. Progress concerning privatization projects has broadly stalled. We understand that a small number of privatization projects are currently in the pipeline, among them Cyprus Telecommunications Authority (CYTA), the National Lottery, and the Troodos Residences. With regard to the privatization of the Cypriot Stock Exchange, a tender procedure was announced in November 2020, while for the Port of Larnaca a concession agreement for redevelopment was signed in December 2020.

In terms of Cyprus' political environment, we would expect a continuation of sound and responsive policy-making also following the upcoming national election on 30 May. According to latest polls, the Democratic Rally (DISY) remains the frontrunner and could obtain roughly 28% of the votes (2016: 30.7%). The biggest opposition party, AKEL, currently polls at around 23%. Looking at the geopolitical context, we remain vigilant regarding developments over ongoing and temporarily growing tensions with Turkey over oil and gas drilling activity.

Fiscal Sustainability

The negative effects from the corona crisis are taking their toll on public finances, turning a headline surplus temporarily into a high deficit, and briefly reversing the downward trend of a still elevated public debt ratio. Fiscal sustainability thus continues to constitute a key credit weakness in our view, but we emphasize notable progress made in terms of fiscal consolidation prior to the outbreak of Covid-19, giving us some confidence with regard to the sovereign's ability to bring the public debt ratio on a firm downward trend in the aftermath of the crisis. Risks to fiscal sustainability persist in view of comparatively high level of public guarantees and an elevated stock of NPEs in the relatively large banking sector, notwithstanding a marked downward trend and enhanced capital buffers over the last few years. Lower revenues due to the termination of the ICS should weigh on the fiscal outcome going forward, while further implementation of the NHS may turn out to become financially more demanding than foreseen. A large cash buffer and benign debt profile as a result of sound debt management, along with a likely continuing favorable financial market environment against the backdrop of a very accommodative monetary policy, balance these risks to some extent.

Cyprus' positive development of the general government budget balance since 2015 came to an abrupt halt last year on account of the corona crisis. Preliminary data shows that Cyprus' general government balance shifted from a surplus to the tune of 1.5% of GDP in 2019 to a marked deficit of 5.0% of GDP in 2020, on the back of both falling revenue and strongly increasing expenditure in the face of containment measures to protect society and aid businesses and households. According to the Ministry of Finance (MOF), total revenue dropped by 3.8%, mainly due to falling revenue from tax on production and imports (-9.0%) as well as from taxes on income and wealth (-1.5%). Total outlays leapt by 11.5% against the backdrop of having to cushion the fallout from the crisis. We note that the fiscal impact of support measures turned out to be lower than expected, thus offering space to provide more targeted support to the tourism industry and provide ongoing support to the economy.

Looking at the current year, the budget was narrowly approved by Parliament this January, after having been rejected before, including additional measures to aid the economy of approximately 1.5% of GDP (MOF data). Further implementation of the NHS amid the second phase of the NHS reform, which started in June 2020, will contribute to an increase of government expenditure for this year. Interest subsidy schemes for new business loans and housing loans were estimated to exert a deficit-increasing impact of about 0.3% of GDP, but have been extended by six months in February, partly subject to approval of the European Commission. We understand that some of the Covid-19 measures, in particular some of the labor market support schemes, were extended until March 2021, and should thus add to the assumed headline deficit. Overall, we expect a headline deficit of roughly 3.0% of GDP for 2021, acknowledging that this estimate is subject to an extremely high degree of uncertainty, essentially as the Covid-19 pandemic remains unpredictable not least against the backdrop of the spread of virus mutations, but also due to uncertainties regarding the revenue intake against the background of the terminated ICS. Contrary to that, upside risks to our projection relate to EU funding via RRF which we did not incorporate at this stage. On a positive side note, we welcome the authorities' forward guidance, provided through the inclusion of a medium-term perspective by the MOF in its DBP21.

Following a downward-trending debt-to-GDP ratio since 2014, general government debt leapt from a still elevated 94.0% of GDP in 2019 to 118.2% in 2020. Building on our assumption of an expected GDP growth rebound in 2021 and above euro area growth in the medium term, as well as a gradual return to a balanced budget and fiscal consolidation efforts, we estimate that Cyprus' public debt ratio will shrink to about 111.4% of GDP this year, before approaching the 100%-mark in 2022, thereby embarking on a downward trajectory.

We think that fiscal consolidation will be supported by the government's ability to draw on a sizable cash buffer, at 28.8% of GDP (currency and deposits, assets, general government) the highest among the EU countries as of Q3-20, as well as by the authorities' sound debt management, translating into a benign debt profile. Cyprus' weighted average maturity has increased significantly over the recent years, climbing to 7.9y in 2020 (2019: 7.4y, 2012: 4.5y). Furthermore, the share of debt due within twelve months remained broadly stable recently (2020: 9.7%), and the share of official loans accounts for a third (32%) of public debt; floating rate debt makes up for 29% of the debt portfolio, down from 46% in 2016.

In addition, debt affordability should continue to increase. The weighted average cost of debt dropped to as low as 1.8% at the end of 2020 (2012: 4.2%, MOF data). Interest expenditure fell by 3.0% in 2019-20, amounting to 2.4% of GDP in 2020 (5.6% of total revenue). Moreover, given the ECB's ongoing accommodative monetary policy, we expect financial market conditions to remain favorable. The ECB increased its overall PEPP envelope by EUR 500bn to a total of EUR 1,850bn in December, while the horizon for net purchases under PEPP was extended to at least the end of March 2022, along with extended and enhanced refinancing operations (TLTRO, PELTRO). The Eurosystem's cumulative net purchases of Cypriot government bonds under PSPP as at the end of Feb-21 were EUR 3.4bn compared to EUR 3.3bn at the end of Dec-20. The cumulative net purchases of ECB for Cyprus under PEPP were EUR 1.7bn as at the end of Jan-21.

Thus, the total net purchases under the two programs sum up to EUR 5.14bn or roughly 21% of the outstanding public debt.

That being said, considerable fiscal risks remain in place and have increased in the wake of the corona crisis. Contingent liability risks concern Cyprus' large banking sector, which remains highly concentrated and which after years of deleveraging stood at 276.9% of GDP in terms of total assets in Q3-20 (Q3-19: 266.2%). Despite significantly shrinking over recent years, the NPE ratio remained the second highest in the EU as of Q3-20, standing at 11.2% (EU: 2.4%, EBA data). Drawing on more comprehensive CBC data referring to Nov-20, the NPE ratio fell to 19.1% (Nov-19: 28.6%). Due to the sale of NPE by Bank of Cyprus ('Helix 2 Portfolio B', EUR 545mn) agreed in Jan-21, the stock of NPEs could be further reduced this year. However, we would flag the risk for these to rise again, as moratoria will phase out at some point and inevitable corporate insolvencies should put pressure on banks' loan portfolios. As highlighted by CBC data, almost half of Cypriot performing loans (48%) were subject to moratoria as of Sep-20. Loans to corporates in the trade sector, in accommodation/food services, and in the arts/recreation/entertainment category, which are among the most affected industries by the lockdowns, account for more than a third of banks' exposure to NFCs (Sep-20: 35.3%).

We note that, according to Cypriot Asset Management Company KEDIPES (Sep-20), the pandemic has significantly affected activities and the progress of key projects, not least due to decreed suspension of instalments, and that interest in participating in the government-backed ESTIA scheme, which aims at facilitating NPE restructuring, was low. On the other hand, we would raise some concern over the new foreclosure framework which came into effect in June 2020 following confirmation of its constitutionality by the Supreme Court, and which seems to enable indefinite extension of decisions under certain circumstances, thus potentially delaying resolving NPE issues. Profitability of the banking sector has turned for the worse in 2020, underperforming against the EU, judging by a negative ROA (Q3-20: -0.4%, EU: 0.2%, EBA data). This being said, capital buffers have been significantly strengthened, comparing favorably against the EU, with the CET1 ratio at 16.6% in Q3-20 (Q3-19: 15.9%, EBA data) vs. 15.4% for the EU, thus equipping the sector with some room to maneuver.

We have to highlight a relatively high level of public guarantees, observing that the government expects these to amount to 19.2% of GDP in 2020 and to diminish to 18.4% of GDP this year (DBP21), of which 9.4% and 8.5% of GDP respectively would relate to the financial sector. Further to contingent liabilities and hence risks on the fiscal side, we would point to risks pertaining to NHS, as the Covid-19 crisis led to only moderate health contributions, putting some pressure on the government to cover for deficits of the Health Insurance Organization.

Foreign Exposure

We continue to regard Cyprus' external position as a source of vulnerability weighing on our credit assessment of the sovereign, despite improvements in the highly negative net international investment position (NIIP) over recent years prior to the corona crisis.

Cyprus' current account deficit looks set to have widened significantly in 2020, amid a considerably squeezed services surplus on the back of collapsing tourism and transport exports as the corona crisis took its toll. From -6.3% of GDP in 2019, the current account deficit expanded to -10.1% of GDP as of Q3-20 (four-quarter-moving-sum). While the deficit in goods trade shrank by 1.5 p.p. to -19.3% of GDP from Q4-19 to Q3-20, the diminishing trade in services surplus more than offset this effect, dropping 5.4 p.p. to 14.4% of GDP. If and when tourism recovers as vaccination progresses and as confidence is regained, we expect the negative current account balance to narrow in the current year, although it may take longer to reach the pre-pandemic level. In this respect, the current EU-level discussions about a possible vaccine passport will be of great interest. As far as goods-related shipping is concerned, we currently do not expect lasting damage from the pandemic, but would follow developments closely.

Against this backdrop, the current account for now seems set to do little to improve the considerably negative net international investment position (NIIP). To the contrary, the latter has temporarily reversed its positive trend, coming to -128.4% of GDP in Q3-20. Adjusting for the pronounced negative position related to SPEs, the NIIP amounted to a still rather high net -44.0% of GDP in Q3-20. The NIIP excluding non-defaultable instruments (NENDI), which stood at 164.6% of GDP in Q3-20 (Q3-19: 159.8%), corroborates reservations over risks from the external exposure, despite an equally positive development over the last few years. With a view to ongoing high gross external debt, which excluding intra-company debt posted at about 284% of GDP in Q3-20, we would continue to monitor developments here. With the ICS having been closed from Nov-20 (see above), direct investment is likely to decline going forward. A possible change in the post-Brexit behavior of UK citizens as the previously dominating European tourist group, which might be more reluctant to acquire holiday homes, could potentially add to this to some degree.

Rating Outlook and Sensitivity

Our rating outlook on the Republic of Cyprus is stable. We perceive current downside risks regarding the macroeconomic performance and the fiscal outlook as being offset by substantial monetary and fiscal EMU/EU-level support to overcome the fallout from the pandemic and spur transition towards more sustainable economic growth, as well as by the above-mentioned factors mitigating fiscal risks. We have to emphasize that the assessment and interpretation of economic developments remains considerably more challenging than under normal circumstances, as is the case for other indicators, in particular from the fiscal realm.

We could lower the sovereign's credit ratings or outlook if deteriorating public finances become more entrenched, and the debt-to-GDP ratio remains elevated or continues to rise. This could be the case if contingent liabilities via the banking sector and/or guarantees materialize. Such a risk could become more dominant in a scenario featuring an extended economic downturn if the detrimental effects of the pandemic are prolonged, and long-term scarring effects in the vital tourism industry become visible. The latter could be the case if wide-spread immunization against Covid-19 proved difficult to achieve.

Conversely, a positive rating action could be prompted if medium-term growth prospects improve visibly, on the back of a stable recovery from the pandemic possibly boosted by effective implementation of NGEU-backed structural reforms and/or progress in terms of economic diversification. Continued significantly falling NPE ratios could serve as another trigger for us to consider raising Cyprus' credit ratings or the outlook, 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]	2015	2016	2017	2018	2019	2020e	2021e
Real GDP growth	3.2	6.4	5.2	5.2	3.1	-5.1	3.5
GDP per capita (PPP, USD)	31,747	35,745	38,125	40,180	41,656	39,079	41,364
HICP inflation rate, y-o-y change	-1.5	-1.2	0.7	0.8	0.5	-1.1	0.8
Default history (years since default)	2	3	4	5	6	7	8
Life expectancy at birth (years)	81.8	82.7	82.2	82.9	82.3	n.a.	n.a.
Fiscal balance/GDP	-0.9	0.3	1.9	-3.5	1.5	-5.0	-3.0
Current account balance/GDP	-0.4	-4.2	-5.3	-3.9	-6.3	n.a.	n.a.
External debt/GDP	1258.8	1144.4	1030.4	900.2	849.0	n.a.	n.a.

Source: International Monetary Fund, Eurostat, 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.]

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.

ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demographics
Labor	Equality	Technology & Infrastructure	Saftey & Security	**Judicial system**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	**Business Environment**	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

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

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. This sovereign rating is an unsolicited credit rating. The Cypriot Ministry of Finance (MOF) participated in the credit rating process as MOF 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 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	YES
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, ECDC, 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.

Disclaimer

Any rating issued by Creditreform Rating AG is subject to the Creditreform Rating AG Code of Conduct which has been published on the web pages of Creditreform Rating AG. In this Code of Conduct, Creditreform Rating AG commits itself – systematically and with due diligence – to establish its independent and objective opinion as to the sustainability, risks and opportunities concerning the entity or the issue under review.

When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

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