Creditreform Sovereign Rating

Creditreform Rating
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Rating Object	Rating Information		
REPUBLIC OF CYPRUS	Assigned Ratings/Outlook: **BB /positive**		Type: Follow-up Rating, unsolicited
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 24-11-2017 “Sovereign Ratings”	

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Rating Action

Neuss, 24 November 2017

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

Key Rating Drivers

1. Output expansion has further accelerated; backed by the dynamic tourism sector, vivid investment activity, and a recovering labor market, we expect real GDP growth to remain strong in the medium term
2. Thanks to buoyant growth and sustained primary surpluses, general government debt-to-GDP is set to follow a downward trajectory and fall from its current high level to below 90% by 2020
3. Despite signs of improvement, very high private debt and an exceptionally high stock of NPEs continue to weigh heavily on the banking sector, still entailing large contingent liability risks
4. Irrespective of important structural reforms over the recent years, slowing reform process should be revitalized to improve relatively weak business environment
5. Although biased by large ship-owning SPEs, improving net international investment position remains highly negative

Reasons for the Rating Decision

Creditreform Rating has revised its outlook on the Republic of Cyprus to positive from stable. The positive outlook is underpinned by our expectation that (i) the Cypriot economy will continue to experience strong growth; (ii) strong tax revenue collection will result in sustained primary surpluses and general government debt will fall below 100% of GDP in 2017; and (iii) the banking sector will make progress in reducing its very large stock of non-performing exposures (NPEs), coupled with a continued deleveraging in the private sector.

Taken together, the Republic of Cyprus's creditworthiness continues to be constrained by its very high public, private, and external debt levels and large contingent liability risks owing to the banking sector, balanced by the authorities' generally sound policy-making, the fiscal headway being made, and the strong macroeconomic performance.

The latter has gathered further momentum since the Cypriot economy emerged from its three-year recession in 2015. After having expanded by 2.0% in 2015, real GDP rose by 3.0% last year, thus placing Cyprus among the top-performing euro area member states and well above the euro area average of 1.8%. Output expansion came on the back of vivid domestic demand. Private consumption spending increased by 3.3% in 2016 (2015: 2.6%), buttressed by improving labor market conditions and rising real wages. While the annual unemployment rate fell considerably from 15.0% in 2015 to a still high 13.0%, real wages increased by 1.2% (Cystat data, 2010-14 avg.: -1.0%). Total investment displayed stellar growth, increasing by 35.0% as compared to 2015 when investment rose by 13.0%. Last years' investment growth was mainly driven by investment in transport equipment – investments in ships and aircrafts skyrocketed from EUR 62.5m to 734.9m in 2015-16. When accounting for this one-off effect, gross fixed capital formation increased by a still solid 4.2%. At the same time, large-scale transport investment resulted in brisk import growth, which came in at 6.6% (imports of goods +10.6%), and a negative contribution of net external trade.

Moreover, Cyprus's economy can be characterized as relatively wealthy and exhibits a well-diversified service sector. According to IMF data, GDP per capita increased to USD 34,961 in PPP terms, well above Portugal (USD 28,916) or Greece (USD 26,829) and somewhat below the euro area median (USD 36,826). The highly productive services sector (86.5% of GVA) rests on multiple pillars, the most prominent being the tourism sector, which has recently been a pivotal engine of growth. Household spending and employment as well as exports of services (2016: +7.9%) are benefiting from booming tourism. Tourist arrivals hit a new all-time high in 2016, leaping by 19.8% to 3.187m – facilitated by an extension of the season and better flight connectivity.

Looking ahead, we expect economic prospects to improve further, with GDP growth accelerating in 2017-18 and remaining robust in the medium term. Latest data suggests that the thriving tourism industry and a favorable development of the labor market should translate into strong private household spending which we believe to be the main driver of growth going forward. The benign outlook for the labor market and tourism should more than offset the dampening effect of inflation which is set to return after three years of falling prices.

Employment growth continued on its upward trajectory and was among strongest in the euro area in the first half of 2017. Employment increased by 4.3 and 3.4% y-o-y in Q1 and Q2 respectively; in Q2-17 the employment rate stood at 64.9%, the highest level since Q1-12. Meanwhile, unemployment fell to 11.3% (quarterly avg., s.a.), down from 12.8% a year before. Tourist arrivals are likely to reach new record highs in 2017, further supporting consumption as well as export growth. The first eight month of 2017 saw another sharp increase in arrivals, as the number of arrivals exceeded the previous year's level by 14.7%. Also, we believe that growth will be supported by robust investment activity, largely driven by the gradual recovery in the construction sector, which is underpinned by improving sentiment indicators and the increase in building permits. In the first seven months of 2017, building permits for residential and non-residential property have edged up by 13.3 and 10.8% y-o-y respectively. Notably, Cystat data indicates a significant increase in permitted large-scale construction projects (by 58.1% to 196). The incipient recovery in construction is also visible in the development of house prices which have recorded positive yearly growth rates since Q4-16 (Eurostat data). Furthermore, gross value added in the construction sector has been growing at double-digit rates since Q2-16, displaying a further pick-up recently (Q1-17: +28.7%, Q2-17: +17.0%) – albeit from low base levels.

For the current year we expect real GDP growth to come in at 3.7%, followed by an equally strong 2018 (3.2%), as we assume that the momentum of the first half of 2017 can be sustained. Against the backdrop of strong private consumption growth, which posted at 2.5 (Q1-17) and 3.5% y-o-y (Q2-17), quarterly GDP growth picked up to 3.7 and 3.5% y-o-y in the first and second quarter respectively. According to the Cystat flash estimate, GDP grew by 3.9% in Q3. In nominal terms, real GDP now stands only some 3% below the pre-recession peak in Q2-11 (Q2-16: 6.4%).

Against the background of strong macroeconomic performance, Cyprus's public finances continued to improve significantly. While strong tax revenue collection boosted the revenue side of the budget, expenditure was contained, mainly due to a decline in intermediate consumption and compensation of employees. Notably, general government expenditure was brought down from 40.2 to 38.3% of GDP, or by 2.5% to EUR 6.9bn in nominal terms. Hence, the headline balance moved into surplus for the first time since 2008, posting at 0.5% of GDP in 2016, up from -1.2% of GDP. With a primary surplus of 3.0% of GDP (2015: 1.7%), Cyprus not only recorded one of the highest primary surpluses in the euro area – the sovereign outperformed its budgetary target once again, as the Draft Budgetary Plan 2017 foresaw a surplus of 2.3% of GDP.

Meanwhile, debt has become more affordable and borrowing conditions have improved. Cyprus's interest payments only amounted to 6.6% of its general government revenue, after 7.3% in 2015. The sovereign continues to benefit from the large share of official low-interest loans which account for around 56% of general government debt (as of Sep-17). What is more, the authorities have engaged in sound debt management operations to reduce debt servicing costs and to improve the maturity profile. Since September 2016 Cyprus has paid down roughly 30% of its IMF loan, reducing its IMF-related debt to EUR 681.9m (Sep-17) – including an early repayment in July 2017. The ESM loan (EUR 6.3bn) will not be due before 2031, whilst the loan by the Russian Federation (EUR 2.5bn) matures in 2021. In June 2017 the sovereign continued to take advantage of the benign interest rate environment and its regained access to the international capital market, issuing a 7-year Eurobond amounting to EUR 850m at a coupon of 2.75%, after tapping the domestic market earlier this year. Accordingly, Cyprus's debt maturity profile has smoothened significantly, as the total average maturity increased from 4.7y at the end of 2012 to 7.4y at the end of 2016 (marketable debt from 2.7 to 4.9y in 2012-16) and saw a further improvement to 7.3y (5.2y) in July 2017. We also assess an ongoing diversification of the Cypriot investor base by type and by residence. Bond yields have developed favorably over recent months, with the CYGV 2.750 27-Jun-2024 MTN trading at around 1.27% at the end of October and the yield of the Eurobond issued on 27-Jul-16 having come down to 1.01%.

With a view to 2017-18, we believe that the targets for the headline balance put forward in the recently published Draft Budgetary Plan 2018 (DBP-18) – 1.0 and 1.3% of GDP, respectively – are feasible, and expect the fiscal position to strengthen. We believe that buoyant growth will warrant a continued strong tax revenue collection. We assume that tax receipts should more than make up for the fiscal impact of measures such as lower taxes on income and wealth, i.e. the abolition of the immoveable property tax, and the termination of the temporary contribution on public and private sector emoluments. At the same time, fiscal risks stemming from the expenditure side are somewhat mitigated by the collective wage agreement between the government and public sector labor unions, which are envisaged to contain wage increases and suspend new hires. On the other hand, social payments are likely to be limited by the improving labor market going forward.

Fiscal developments in the first three quarters of the year indicate that the sovereign has gone a long way in reaching its fiscal targets for 2017. According to latest Ministry of Finance data, the general government headline balance (cash basis) stood at EUR 429.0m in Jan-Sep 2017, compared to EUR 143.4m in the last year's first nine months. In this regard it has to be highlighted that total revenue in Q1-Q3 exceeded the previous year's level by 9.0% (direct and indirect taxes +7.7%), while total expenditure ticked up by 1.7%. Apart from its healthy fiscal position, the sovereign has built up sizeable cash buffers (currency and deposits) which amounted to 14.0% of GDP in Q2-17 (Q2-16: 9.6%) and may be deployed to meet Cyprus's financing needs.

General government gross debt has started to decrease marginally from 107.5 to 107.1% of GDP in 2015-16, having increased by 1.8% to EUR 19.4bn in nominal terms. Thanks to buoyant growth and sustained primary surpluses, public debt is set to follow a downward trajectory in the medium term – we expect debt-to-GDP to fall from its current high level to below 90% by 2020. Having said this, we assume that debt-to-GDP is to cross the 100%-mark this year, as the government made another early repayment on 06-Nov-17. Drawing on existing cash buffers, the authorities reimbursed a loan held by the Central Bank of Cyprus (CBoC), totaling EUR 621.2m or 3.4% of 2016 GDP.

In the medium term, rising spending pressures and weaker discipline to contain the public sector wage bill may lead to some fiscal slippages. Likewise, there are some uncertainties regarding the impact of the new National Health System (NHS) which is designed to be fiscally neutral, as health expenditure is foreseen to be contained more efficiently and the NHS budget must be balanced. In June 2017, the State Health Service Organization Law of 2017 and the General System of Health Law 2001-2017 were adopted and the implementation of the first phase of the NHS is planned for June 2019. That said, windfall profits emanating from the outperformance of tax revenue targets or the monetization of gas fields could provide some fiscal leeway. The same counts for potential privatization proceeds, which we do not factor into our baseline scenario as the privatization process has slowed down significantly. The implementation of the Larnaca Port privatization is ongoing, but privatization of the Cyprus Stock Exchange, CYTA, the National Lottery and the Troodos area are subject to delays. In the DBP-18, the authorities envisage resuming the privatization plan.

While the forthcoming presidential elections (January 2018) might entail minor fiscal slippages, sound fiscal policy-making should not be jeopardized going forward. By contrast, the exceptionally high stock of NPEs coupled with the disproportionally large banking sector continue to give reason for concern, as further recapitalizations by the general government might become necessary. Total bank assets still make up for approx. 502% of GDP in 2016 (IMF data), down from 557% a year before. According to CBoC data, the NPE-ratio (all banks including the co-op sector on a consolidated basis) continued to decrease but remains unsustainably high. While the NPE provision coverage rose to 47.1% in Q2-17 (Q2-16: 38.8%), NPEs made up for 44.1% of total facilities, down from 45.0% in the first quarter, but only 1.9 p.p. below the level of Q2-15. Concurrently, the NPE workout related to NFCs has advanced further than in the private household sector, with the NPE-ratio for NFCs dropping from 57.2 (Q2-16) to 50.9% (Q2-17) and the share of NPEs for households remaining rather stable at 54.5% (Q2-16: 55.2%). Progress on deleveraging thus appears fairly modest so far, given the strong growth impetus of the economic environment. At the same time, it has to be noted that much of the headway being made was overshadowed by contracting credit. In nominal terms, NPEs declined by 9.7% y-o-y to EUR 22.8bn (Q2-17) within a year and by 18.8% as compared to Q2-15.

To be sure, banks have shored up liquidity, as deposits continued on their upward trajectory and increased to 49.0bn in Sep-17, up from 47.7bn a year before. The loan-deposit ratio has been in decline from 113% to 107% over the same period. Moreover, the capital position has been bolstered over the recent years, although the CET 1 ratio in Q2-17 fell to 14.9% (lowest level since Q1-15), down from 15.7% in the second quarter of 2016.

Provisioning for the very large stock of NPEs continues to put high constraints on banks' credit supply and profitability, potentially hampering economic recovery going forward. Cyprus's banks remain among the least profitable in Europe, with return on assets standing at -2.6% at the end of June 2017, after -0.1% in Q1-17 (EBA data). Also, the outstanding amount of private credit has been contracting since Mar-13 with the yearly rate declining on average by 6.3% throughout 2017 (Aug-17: -4.9%). Demand side factors have also been at play, as the private sector has carried on with deleveraging. The exceptionally high private sector debt level declined from 385.4 to 374.8% of GDP in 2015-16, but remains the highest in the EU. NFC debt, which is largely driven by operations of multi-national enterprises, decreased only moderately from 242.1 to 238.0% of GDP and has risen in nominal terms. Private households' deleveraging was more pronounced, with debt falling to its lowest level since 2010 (136.8% of GDP).

In this regard, the government contemplates stepping up its efforts to improve the functioning of the new insolvency and foreclosure framework which has been underexploited so far. In general, it has to be noted that the pace of structural reforms has slowed since 2015, as was reiterated by the IMF and the EU Commission during their respective post-program evaluation.

Although we still view Cyprus's generally strong institutional framework as supportive of its credit assessment, the reform process should be revitalized to improve the relatively weak business environment. The Cypriot business environment continues to be plagued by considerable weaknesses. According to the Doing Business report 2018, Cyprus was down several places, to rank 53 out of 190 economies (DB17: rank 43). Considerable shortcomings in dealing with construction permits (rank 120), cumbersome registration of property (rank 92), and weak contract enforcement (rank 138) are the main culprits for the relatively feeble performance. Modest quality of contract enforcement and of courts is also underscored by the World Governance Indicator (WGI) Rule of Law, which ranks Cyprus at rank 52 out of 209 economies – a significant decline as compared to last year when the economy stood at rank 39. In addition, the effectiveness in policy formulation and implementation appears to deteriorate, with Cyprus slipping from rank 40 to 46/209 on the WGI Government Effectiveness.

The government has made limited progress with regard to enhancing the efficiency of public administration. To the contrary, in December 2016 the House of Representatives rejected several bills on horizontal reforms which were foreseen by the economic adjustment program, and a revised draft for legislation is being prepared. The local government reform is still awaited, with bills and respective regulations being discussed in the House. Legislation for establishing a commercial court is pending; currently the bill is under legal vetting. We note that significant strides in implementing reforms cannot be expected until the beginning of next year against the backdrop of the upcoming election.

The Cypriot economy appears to remain highly reliant on external funding, with a net international investment position (NIIP) of -132.1% of GDP in 2016 (CBoC data), one of the most negative readings in Europe. That said, Cyprus's NIIP was up from -149.2% of GDP in 2015. More importantly, external statistics are biased by operations of ship-owning special purpose entities (SPEs). While these SPEs account for a large stock of loans which are used for financing ship acquisition, they have no close links with Cyprus's real economy. According to the CBOC, SPEs account for almost 60% of net external liabilities. External debt increased from 572.7 to 592.0% of GDP in 2015-16. However, standing for 273% of GDP in 2016 (2015: 236% of GDP), 'Other sectors' account for the largest share of external debt. General government external debt amounted to only 85% of GDP, mainly due to its official loans, while external debt of deposit-takers has significantly come down over recent years, having dropped from 147% of GDP in 2015 to 116% in 2016. SPEs also had a bearing on the development of the current account deficit which widened to 4.9% of GDP in 2016, after having narrowed from 6.0 to 1.5% of GDP in 2012-15. The deterioration was mainly driven by the large one-off ship import which resulted in a sharp deterioration of the trade of goods balance (from -16.7% to -21.3% of GDP). By the same token, the primary income balance turned negative to -1.6% of GDP, after posting at 0.6% of GDP in 2015.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating is positive, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to improve over the next 12-18 months.

We could raise Cyprus's rating if output expansion maintains its current momentum and the labor market continues to improve, if the banking sector's asset quality is enhanced, or if general government debt continues on its downward trajectory. Furthermore, the rating could be upgraded if the reform process eventually advances, thus contributing to an enhancement of the efficiency of public administration and the justice system.

While the positive outlook indicates that a rating downgrade is rather unlikely, downward pressure on the outlook or rating could arise if we observe serious delays in the implementation of structural reforms, if public finances are subject to substantial fiscal slippages so that debt remains at its current high levels, or if the pace of economic growth slows down significantly. In the same vein, slower progress or even setbacks in NPE resolution would pose significant downside risks to economic recovery as well as to fiscal sustainability. Adverse growth effects could stem from structurally weaker growth of key trading partners such as Greece (10% of 2016 exports) and the UK (12%). The UK's decision to leave the EU may have negative repercussions, as the Cypriot economy is heavily dependent on external demand from the UK, but we do not expect any significant impact to materialize in 2017-18. To be sure, a disorderly Brexit could entail severe adverse effects going forward.

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Ratings*

Long-term sovereign rating	BB /positive
Foreign currency senior unsecured long-term debt	BB /positive
Local currency senior unsecured long-term debt	BB /positive

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth	-3.1	-5.9	-1.4	2.0	3.0	3.7	3.2
GDP per capita (PPP, USD)	33,554	31,923	32,293	33,621	34,961	36,557	38,006
Inflation rate, y-o-y change	3.1	0.4	-0.3	-1.5	-1.2	1.1	1.2
Default history (years since default)	n.a.	SD	1	2	3	4	5
Life expectancy at birth (years)	79.8	79.9	80.1	80.3	n.a.	n.a.	n.a.
Fiscal balance/GDP	-5.6	-5.1	-8.8	-1.2	0.5	1.0	1.4
Current account balance/GDP	-6.0	-4.9	-4.3	-1.5	-4.9	n.a.	n.a.
External debt/GDP	634.2	591.6	507.6	565.3	570.9	n.a.	n.a.

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

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.

The rating was conducted on the basis of CRAG´s “Sovereign Ratings” methodology. 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 is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used 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, 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 and that the rating action was and is free of any existing or potential conflicts of interest. 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”.

In the case of a 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 regard to the rated entity CRAG regarded available historical data as sufficient.

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

In accordance to 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 CRAG`s default rates are available in the credit rating methodologies disclosed on the website.

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