Creditreform Sovereign Rating

Creditreform Rating
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Rating Object	Rating Information	
REPUBLIC OF CYPRUS	Assigned Ratings/Outlook: **BB+ /positive**	Type: Monitoring, 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:	28-10-2016 26-10-2018 “Sovereign Ratings”

Rating Action

Neuss, 26 October 2018

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

Contents

Key Rating Drivers

1. Strong domestic-demand driven economic expansion, which we expect to remain robust, supported by benign prospects for investment activity and export growth, and a further improving labor market; still very high private sector debt and increasing dependency on tourism may pose risks to the macro outlook
2. Reform momentum has slowed since Cyprus exited the program, but notable progress with regard to policies targeted towards restoring banking sector health; room to improve on quality of public administration and judicial system
3. Persisting fiscal vulnerabilities, reflected by very high government debt, a still very high stock of non-performing exposures, and considerable contingent liabilities; elevated interest-to-revenue ratio in EU-comparison
4. Despite increasing in 2018 due to the CCB operation, sizable primary surpluses and resilient growth should buttress firm downward trajectory of debt-to-GDP, waning banking sector risks
5. External debt remains very high and NIIP largely negative, though inflated by SPE-related economic activity; current account deficit will likely remain sizable going forward, while SPE-adjusted readings more moderate

Reasons for the Rating Decision

Creditreform Rating has raised its ratings on the Republic of Cyprus to “BB+” from “BB“. Our decision is underpinned by (i) continued strong economic growth accompanied by a brightening labor market situation; (ii) the ongoing fiscal consolidation resulting in a favorable debt trend, driven by tax-rich growth and sustained expenditure containment; and (iii) palpable progress in dealing with very high level of non-performing exposures (NPE) in the banking sector and related uncertainties.

The outlook on the Republic of Cyprus remains positive, reflecting our expectation that (i) the Cypriot economy will exhibit robust medium-term growth and the labor market will continue to recover; (ii) the debt-to-GDP ratio will remain on a firm downward trajectory; and (iii) banking sector risks will continue to subside, as the NPE ratio should further decrease.

Our assessment of Cyprus's macroeconomic performance reflects significantly improved economic conditions, which have translated into strong economic growth. Last year, the Cypriot economy was able to outperform the largest majority of its euro area peers again. According to latest national accounts data, real GDP expanded sharply by 4.2% in 2017 (EA-19 average: 2.4%), the second-highest growth rate recorded since 2008, after coming in somewhat higher in 2016 when total output rose by 4.8%.The rapid economic recovery has lifted Cyprus' per capita income to a fairly high level. GDP per capita thus amounted to USD 37,172 in 2017 (in PPP terms, IMF data), up from 35,386 a year before, but still below the EU-28 total of USD 41,339. Hence, speaking in terms of income convergence, Cyprus is gradually approaching the EU-28 average, after having fallen to 87% in 2014 (2017: 90%).

Cyprus' economic expansion remains largely driven by vibrant investment activity, which jolted by 26.8% last year after a stellar growth of 41.8% in 2016. On aggregate, total gross fixed capital formation has climbed to its highest level since 2010. In the current cyclical expansion, investment is increasingly determined by the shipping industry, i.e. the transfer of transport equipment, and construction activity mainly related to the booming tourism industry. Buttressed by the upscaling of accommodation capacities and residential real estate, total construction investment increased by 24.8%, totaling 9.3% of GDP in 2017 (2015: 6.9%). We note that large swings in transport equipment investment are largely explained by the transfer of economic ownership of mobile transport equipment (mainly ships) by SPEs. On the back of investment in ships and aircraft, which rose by 19.0% to EUR 1.1bn, investment in transport equipment rose to 6.1% of GDP, after having leapt from 0.6 to 5.5% of GDP in 2015-16.

Meanwhile, real GDP growth was also supported by private and public consumption, contributing 2.7 and 0.5 p.p. respectively. Private household spending was aided by the ongoing labor market recovery, rising by 4.1% on the year (2016: 4.5%). By contrast, net external trade dragged down economic growth by 3.9 p.p. (2016: -1.2 p.p.), as domestic demand significantly boosted imports which grew twice as fast as exports.

More recently, Cyprus has continued on its recovery path with yearly growth rates of 4.1 and 3.9% in the first and second quarter of 2018, now posting eleven consecutive quarters with growth rates of 3.5% or more. In Q2-18 real GDP stood 3% above its pre-crisis peak reached in Q2-11. Looking forward, we expect Cyprus to sustain its remarkable growth momentum, with real GDP rising by 3.9 and 3.8% in 2018 and 2019 respectively. Economic activity should be mainly buoyed by brisk investment activity and solid private consumption, while net exports should continue to drag on growth due to import-intensive domestic demand.

Besides benign business sentiment in industry and construction, investment is likely to benefit from private and public sector projects in the areas tourism, energy, transport, and education, e.g. investments associated with the Ayia Napa and Paralimni marinas, the ports of Limassol and Vasiliko, or the construction of a casino resort. Further infrastructure projects are reportedly related to educational establishments, recreational facilities, and citizen service centers. The positive outlook for residential construction also bodes well for investment, mirrored by rising building permits and recovering house prices. While the number of residential building permits between January and June exceeded the previous year's reading by 8.9%, house prices turned the corner towards the end of 2016 and have been increasing moderately since then. Furthermore, capacity utilization in the industry sector has been running above its long-term average for several quarters (Q3-18: 61.8% vs. 2009-2018 avg. 58.7%).

Private household spending is likely to remain resilient in view of upbeat consumer sentiment as well as continued employment growth and gradually rising wages (average monthly earnings Q2-18: +1.4% y-o-y, Q2-17: 0.3%), buttressing disposable income. Still, after years of dissaving, consumption should be somewhat curbed by household deleveraging. Previously, the private household sector displayed a negative saving ratio for four consecutive years (latest available data 2016). At the same time, we expect exports to benefit from inflows of tourists visiting Cyprus. Last year, a new historical high was reached, with the number of tourist arrivals rising by 14.6% to 3.65m (2016: 19.8%) and generating significant revenues of roughly EUR 2.64bn (2014: 2.36bn). Fostered by expanded hotel and air transport capacities, we expect the momentum in the tourism sector to persist. Tourism is set to expand further, thereby facilitating exports of services, as arrivals up to August 2018 have climbed to 2.72m – already surpassing the previous year's level by 8.0%. On a positive side-note, export expectations of the industry sector have shown a strong performance throughout 2018.

What is more, economic activity is likely to be aided by the fragile recovery in bank lending going forward. Central Bank of Cyprus (CBC) data points to a continued but hesitant development in bank lending with the volume of total new business loans expanding slowly. Results of the bank lending survey signal increasing demand for loans and concurrent unchanged credit standards.

Further out, growth should level off, converging to its potential growth rate which the EU Commission estimates to increase to 2.3% by 2019, as compared to its pre-crisis average of 3.1% (2002-11). We acknowledge that the current boom in Cyprus' tourism industry and the concurrent thrust in investment are likely to have positive repercussions on potential output in terms of capital accumulation, alongside the positive effects of employment growth on labor input. However, an increasing dependency on tourism and the construction sector may pose risks to the macro outlook. It has to be highlighted that Brexit may have adverse effects on external demand for services, in particular on tourism. The UK represents the most important origin of tourist arrivals (2017: 34.3%), albeit the UK's share in the number of visitors has steadily declined over the last decade. That said, we concur with CBC that Cyprus may succeed in attracting international companies currently based in the UK. In addition, abating geopolitical tensions may lead to a reversal of tourist inflows, diverting these to Turkey or destinations in the eastern Mediterranean regions.

We view Cyprus' economic resilience and flexibility constrained by the economy's very high level of private sector indebtedness (incl. debt securities, loans, other accounts payable). Its private household debt fell from 139.4% of GDP in Q1-17 to 124.7% in this year's first quarter. Despite this marked decline, Cyprus' household debt is still twice as high as the euro area average (63.6% of GDP), corresponding to the second highest reading in the EU-28. The same applies to the fall in non-financial corporate debt, which posted at 274.6% of GDP in Q1-18, down from 298.9% a year before. Eurostat non-consolidated financial accounts data is also biased by the economic operations of SPEs. Nevertheless, even when excluding SPE debt, accounting for roughly a third (approx. 76% of GDP in Q1-18, CBC data), NFC debt remains among the highest in Europe, weighing on the private sector's risk-bearing capacities.

Cyprus' jobless rate still appears somewhat elevated, although solid economic expansion led to a continuation of the strong labor market recovery. Thus, annual unemployment inched down from 13.0 to 11.1% in 2016-17 (EA-19: 9.1%), the lowest level since 2011. Drawing on more high frequency data, unemployment continues to decline rapidly, as Cyprus' labor market has enjoyed vivid employment growth over the last quarters. In this year's second quarter, employment edged up by 4.4% y-o-y (seasonally adjusted national accounts data), the fastest growth in the EU-28. Accordingly, the quarterly average unemployment rate (Eurostat, seasonally adjusted, harmonized) dropped to 8.1% in Q2 (Q2-17: 11.4%), posting below the euro area average for the first time since 2012. However, we still assess some labor market deficiencies, most notably concerning the Cypriot youth, since youth unemployment (<25 years) is still elevated, totaling 19.0% of active population in Q2-18, down from its peak of 40.5% in Q3-13. The NEET share of young people has also come down sharply since the second quarter of 2017 (17.4%), but came in at a still high 13.2% in Q2-18 - the third highest reading in the euro area. Moreover, Cyprus performs rather poorly as regards the EU's Social Scoreboard, exhibiting a weak performance in the categories 'equal opportunities and access to labor' as well as 'dynamic labor markets', with most of the indicators standing on watch, critical, and average.

Owing to the remaining labor market slack, wage pressure has been modest so far, translating into improvements in Cyprus' cost competitiveness. In this vein, real unit labor costs decreased by 1.3% in 2017, now standing almost 9% below its 2010 level as compared to a decline of 1.6% in the euro area as a whole (AMECO data). While real labor productivity has been expanding at a modest pace (2014-17 avg. 0.9%), cost competitiveness mainly benefited from wage moderation.

That being said, improvements in cost competitiveness appear to be balanced by weaknesses on the non-cost competitiveness side. The World Bank's assessment attests the Cypriot business environment to be curtailed by burdensome regulations and inefficiencies in public administration, thus holding back investment into the domestic economy. Major weaknesses documented in the latest Doing Business Report 2018 are the treatment of construction permits (rank 120 out of 190 economies) and the enforcement of contracts (rank 138). By the same token, Cyprus fares relatively poorly in the recently published Global Competitiveness Report. Despite the methodological changes by which the World Economic Forum (WEF) tries to better capture a country's capability to grasp opportunities entailed by the fourth industrial revolution, Cyprus still ranks at second to last among its euro area peers at rank 44 (out of 140 economies in total), down from 43/135 in 2017.

In our view, the generally high quality of Cyprus' institutional conditions remains supportive to its credit assessment. We positively note that the economy has greatly benefited from a high degree of ownership, and policies and structural reforms have been closely aligned with EU/IMF-recommendations. Reform momentum, however, has slowed since Cyprus exited the program, and has only gained some traction very recently. Palpable progress was achieved with regard to policies targeted towards restoring banking sector health (see below), but we continue to see room to improve on the quality of public administration, its judicial system, and on enhancing the business environment more generally.

The World Bank's Worldwide Governance Indicators (WGIs) underscores our concerns. In the euro area, Cyprus faces a significant catching-up potential when it comes to the efficiency in the formulation and implementation of policies, being placed at rank 43 (out of 209 economies) as compared with the EA-19 median rank 33. Against this backdrop, we assess a gradual deterioration in terms of the WGI government effectiveness, as Cyprus stood at rank 22 ten years ago. Control of corruption is also an area where we see notable potential for improvement (rank 46), also mirrored by the new evaluation report by GRECO (Group of States against Corruption). The sovereign displays a significant gap concerning the quality of property rights and courts (WGI rule of law), with regard to which the country is ranked at 43/209 (EA-19: 32). Judging by the 2018 edition of the EU Justice Scoreboard, Cyprus' judicial system may apparently be deemed as operating rather inefficiently, being characterized by very lengthy proceedings in resolving cases, resulting in a huge number of pending cases, and the negligible use of ICT between courts and lawyers.

We note that reforms geared towards increasing the efficiency of the judicial systems have advanced over the last months, when a bill for the establishment of an Administrative Court of International Protection was adopted; authorities expect that the court will be operational by the beginning of next year. Also, a bill for the creation of a Commercial Court is pending. Yet, progress is more cumbersome with regard to the clearance of the backlog of delayed cases and the improvement of the insolvency framework. An electronic court administration system is envisaged to be launched in the second half of 2019, while a bill is being discussed which shall amend the Civil Procedure Law. An action plan was formulated in November 2017, with the assessment of the insolvency framework being structured into three phases, but feasible progress is awaiting and not to be expected before 2020. At the same time, the proposed public administration reform is progressing very gradually. After the majority of bills related to the introduction of horizontal reforms were rejected by Parliament, these are being further discussed, with no tangible progress being achieved. In the same vein, the local government reform drags on. While we observe little progress in terms of the privatization plans (see below), headway was made on a legal framework to facilitate Cyprus' investment funds industry, as three new laws were enacted this July.

The sovereign's fiscal position continued to strengthen last year. Up from 0.3% of GDP in 2016, Cyprus achieved a budget surplus of 1.8% of GDP, marking the highest surplus over the last decade. Concurrently, the primary surplus, which had already been one of the highest in the euro area in 2016 (3.1% of GDP), increased to 4.3% of GDP. The final budgetary outcome thus surprised on the upside once again. Alongside strong GDP growth, rapidly growing revenues contributed the bulk (1.0 p.p. GDP) to last year's improvement in the budget balance. Despite the abolition of the immovable property tax and the termination of a temporary contribution on public and private sector remuneration, revenues came in 8.5% above the 2016 level. Social security contributions went up by 10.7% (2016: 4.2%), mirroring the ongoing labor market recovery. At the same time, tax receipts performed strongly, driven by double-digit growth in CIT intakes and VAT-receipts. To be sure, ongoing expenditure containment also had a positive impact on the budgetary outcome. Primary expenditure, which is our favorite measure to assess the sovereign's spending discipline, has continuously lagged nominal GDP growth in 2015-17. Excluding interest payments, government spending rose by 4.9% last year, mainly due to accelerating public investment (+14.0%) and intermediate consumption (+13.2%). On the other hand, spending on the public wage bill (+4.2%) and social benefits (+2.2%) evolved less dynamically.

What is more, we observed further improvements in the sovereigns' debt affordability in 2017. Still being the fifth highest in the euro area, the Cypriot interest-revenue ratio edged down from 7.2 to 6.6% in 2016-17. In general, Cyprus continues to benefit from a significant share of multilateral loans with long maturities. As of Q2-18, official debt, which includes program loans provided by the IMF and ESM, made up for more than half (54%) of the sovereign's debt stock. ESM loans, which account for EUR 6.3bn of consolidated government debt, will not be amortized before 2025. We also note that the Public Debt Management Office (PDMO) has tapped the bond market several times in 2018, thereby demonstrating its ability to issue medium- and long-term debt at favorable rates. PDMO issuance activity has helped to smoothen the sovereign's redemption profile. According to latest available data, the weighted average maturity of debt increased notably from 7.0 (2017) to 8.1 years in Q2-18, indicating reduced rollover risks. Notwithstanding moderate refinancing needs over the next two years, we welcome PDMO's prudent funding strategy as it upholds its commitment to maintain considerable cash buffers (Q2-18: 22.4% of GDP), which are sufficient to cover gross public financing needs for at least nine months. As observed at the beginning of the year, the sovereign's financing conditions remain susceptible to sudden swings in investor sentiment. In response to rising uncertainty regarding CCB's viability and a potential state intervention, the Cypriot spread over German bunds had widened by about 100bp between March and June.

Budgetary developments in the first eight months of the year indicate that the state has gone a long way in reaching its fiscal targets for 2018. Up to August 2018, the sovereign has run a surplus of EUR 732.6m, compared with EUR 433.5m during the corresponding period in 2017. Accordingly, we believe that the fiscal outturn should continue to improve, with the surplus rising to 2.7% of GDP this year. In this context, it has to be highlighted that total revenues continued to grow rapidly in the first eight months, exceeding the previous year's level by 8.8%, while total expenditure rose by only 2.8%. In the second half of the year, expenditure should pick up somewhat, mirroring the government's recent agreement with trade unions on public sector wages. Starting in July-18, the government is gradually reinstating pay cuts affecting employees in the public sector over the past six years. Moreover, the wage agreement provides for a re-introduction of the cost of living allowance and automatic pay increases. To be sure, additional fiscal costs from the implementation of the public sector wage agreement appear moderate. According to Ministry of finance estimates, additional fiscal costs will add up to EUR 20m in 2018 and average at about EUR 45m per year in 2019-23. With regard to next year, the Cypriot government should maintain its prudent fiscal stance, as higher spending on the public wage bill is more than offset by the implementation of revenue-enhancing measures. Alongside a 1 p.p. increase in social security contribution rates, the introduction of a VAT on property land should yield additional revenues of 0.5% of GDP. Furthermore, rising wages and employment continue to stimulate growth in government revenues. As a result, we anticipate fiscal surplus to stand at 2.9% in 2019.

Given that the process of SOE privatization has seen multiple delays in the past, we do not factor in potential proceeds from the sale of state-owned corporations into our budgetary forecasts. Although a law passed by parliament last year scrapped the finance ministry's privatization unit, the Cypriot government announced that it will move ahead with its privatization plans. Nevertheless, we have seen limited progress on SOE privatization in the recent past. While draft legislation to transpose the state-owned Cyprus Telecommunication Authority into a private company was approved by the cabinet, the tender process to develop Larnaca port has been pushed back. Regarding the sale of National Lottery and Cyprus Stock exchange, further progress is not expected before 2019.

Reflecting last year's favorable fiscal performance, public indebtedness experienced a notable decline. Falling from 105.5 (2016) to a still high 96.1% of GDP in 2017, the sovereign's debt-to-GDP ratio dropped below the 100%-mark for the first time since 2012. With regard to 2018, however, public debt is set increase temporarily. Owing to bond issuances (EUR 3.19bn) in the context of the Cyprus Cooperative Bank – Hellenic Bank transaction (see below), we expect the sovereign's debt-to-GDP ratio to increase to levels in the order of 105% before re-entering its firm downward path. From 2019 onwards, debt reduction should mainly be driven by sustained and sizeable primary surpluses, as well as by robust GDP growth.

However, some fiscal risks remain which may lead to a slowdown in debt consolidation. Although the government expects healthcare spending to remain stable at 2016 levels (2.6% of GDP) over the next years, the implementation of its comprehensive healthcare reform may entail some cost overruns. The introduction of the National Health Insurance System (NHIS) is designed to improve the quality and efficiency in the provision of healthcare services. Preparations for the reform, which should be phased in between June 2019 and June 2020, are proceeding as planned. In Q1-18, the law for the establishment of the State Health Service, which will be tasked with the management of public hospitals and primary healthcare-centers, was enacted. Budgetary pressure could also arise if increases in permanent expenditures such as healthcare and public wages are funded by relatively cyclical taxes. In 2015-17, Cyprus experienced a tax rich recovery, with VAT-receipts (+22.9%) and corporate taxes (+18.6%) outpacing nominal GDP growth (+10.3%)

by far. Thus, the revenue side of the budget may be relatively sensitive to a slowdown in economic growth.

Most importantly, the materialization of significant contingent liability risks in the banking sector could derail fiscal consolidation. According to the latest Draft Budgetary Plan, public guarantees are expected to post at 22.5% of GDP in 2018. Overall, the banking sector has posted repeated losses since 2011, mirroring high operating costs, decreasing net interest income and ongoing loan loss provisioning in light of an exceptionally high stock of NPEs. With regard to 2017, both profitability and capital ratios were negatively affected by higher provisioning for bad debts. Due to supervisory pressures, Cypriot banks increased their coverage ratio significantly from 40.1 (Q4-16) to 45.0% in Q4-17. More recently, the coverage ratio stood at 44.2% (Q2-18) broadly on par with EU-28 levels (46.0%), while the CET1-ratio (13.2%) and return on assets (0.1%) compare relatively poorly with EU averages (14.5%; 0.5%, EBA data). Asset quality remains weak, even though NPEs (all banks on a consolidated basis) continued to decline in absolute and relative terms in the year up to Q2-18. As highlighted by Central Bank of Cyprus data, the total volume of NPEs fell by EUR 5.9bn (-26.0% y-o-y) between Q2-17 and Q2-18, with the NPE ratio decreasing from 44.1 to 38.9%. To be sure, the lower NPE ratio was in particular a result of improving asset quality in the corporate sector and NPE sales. In Jun-18, Bank of Cyprus sold NPEs in the amount of EUR 2.7bn to alternative investment manager Apollo Global Management LLC. While the share of household NPEs declined moderately from 54.5 to 50.7%, the drop in the corporate sector's NPE-ratio from 50.9 to 37.5% was more pronounced.

Nevertheless, we acknowledge that Cyprus has forged ahead in restoring stability and confidence in the banking sector in 2018. After the sale of state-owned Cyprus Cooperative Bank (CCB) had failed, Cypriot authorities decided to wind down the bank. To facilitate its liquidation, EU regulators approved the government's plan to inject up to EUR 3.5bn into CCB in Jun-18. While Hellenic Bank acquired EUR 10.3bn of healthy CCB assets consisting of performing loans, government bonds and cash, CCB's non-performing exposures with a book value of EUR 7.0bn were transferred to a publicly-owned residual entity and thereby removed from the banking system. It is expected that income generated by the residual entity, estimated at EUR 0.25bn per year, will accrue to the state budget.

Legislative changes and NPE sales should help to put the banking sector on a sounder footing. Legislative changes should promote a faster workout of NPEs. In July, the Cypriot parliament approved legislation on the sale of loans and securitization, as well as several amendments to the foreclosure framework. The revised foreclosure law should help banks to better deal with strategic defaults. Also, parliament passed ESTIA, a new government scheme aiming at accelerating NPE resolution of mortgages collateralized with the primary residence. The scheme foresees that the state will subsidize a third of the monthly instalment that borrowers will have to pay after the restructuring of their loan. As a result of the aforementioned actions, we expect the NPE ratio to move along a steeper downward trajectory going forward.

Assessing its external position, the Cypriot economy continues to exhibit elevated external funding needs due to high and persistent current account deficits, which we expect to remain sizable. In 2017, Cyprus posted the highest current account deficit since 2010, with the external balance slipping from -5.1 to -8.4% of GDP. To be sure, Cyprus' current account deficit adjusted for SPEs came in lower, but also increased from 0.4 to 3.2% of GDP. While the economy's sizeable trade in services surplus increased to 20.8% of GDP (2016: 20.4%) on the back of vividly rising net receipts from travel (+6.7% y-o-y) and ICT services (+30.6% y-o-y), the trade in goods balance experienced a notable deterioration in 2017. Mirroring strong investment dynamics and rebounding energy prices, capital goods for home consumption and fuel imports rose by 20.0 and 33.3% respectively. As a result, the trade in goods deficit widened from an already high 21.0 to 24.3% of GDP. To be sure, Cyprus' trade in goods accounts are heavily distorted by transactions attributed to ship-owning SPEs. Given that these entities are weakly linked to the domestic economy, their liabilities do not represent a substantial risk to the Cypriot economy, in our view. Likewise, SPE-related loans have a negative impact on the net international investment position (NIIP). While the headline NIIP was reported at -121.5% of GDP in 2017 (2016: -123.0%), SPE accounted for roughly two thirds of the NIIP. In particular, external debt remains at elevated levels, despite the recent decline from 576.5 to 554.5% of GDP in 2016-17. However, we acknowledge that the composition of the economy's external debt stock has become less risk sensitive in recent years. The share of short-term external debt has almost halved from 50.0 to 27.1% since 2012, reflecting ongoing external deleveraging in the Cypriot banking sector. In 2012-17, deposit-taking corporations reduced their external debt from 265.5 to 100.8% of GDP.

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 12-24 months.

We could raise Cyprus' sovereign rating if we observe robust growth in the medium term, coupled with further improving labor market conditions, or if the structural reform process is speeded up, leading to a marked improvement in institutional conditions. In the same vein, we could consider an upgrade if general government debt enters a steep downward trajectory in the years beyond 2018, or if NPE resolution in the banking sector advances faster than currently expected.

While the positive outlook indicates that a downgrade is rather unlikely, downward pressure on the outlook or rating could arise if significant fiscal slippages or further government interventions in the banking sector lead to delays in debt reduction or even a renewed increase in the government's debt-GDP-ratio. A negative rating action could also be prompted if medium-term growth falls significantly short of our current expectations. Given the economy's strong linkages to the UK, a disorderly Brexit would likely have adverse effects on GDP growth via the trade channel.

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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

	2013	2014	2015	2016	2017	2018e	2019e
Real GDP growth	-5.8	-1.3	2.0	4.8	4.2	3.9	3.8
GDP per capita (PPP, USD)	32,030	32,473	33,905	35,386	37,172	39,302	41,572
HICP inflation rate, y-o-y change	0.4	-0.3	-1.5	-1.2	0.7	0.6	1.1
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	82.5	82.3	81.8	82.7	n.a.	n.a.	n.a.
Fiscal balance/GDP	-5.1	-9.0	-1.3	0.3	1.8	2.7	2.9
Current account balance/GDP	-4.9	-4.3	-1.5	-5.1	-8.4	n.a.	n.a.
External debt/GDP	569.1	554.3	572.6	576.5	554.5	n.a.	n.a.

Source: International Monetary Fund, Eurostat, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	25.11.2016	BB /stable
Monitoring	24.11.2017	BB /positive
Monitoring	26.10.2018	BB+ /positive

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. Central Bank of Cyprus (CBC) and the Cypriot Ministry of Finance (MoF) participated in the credit rating process as the authorities commented on a draft version of this report. Thus, the report represents an updated version, which was augmented in response to the factual remarks of CBC and MoF. The rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". 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 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 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 each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

Disclaimer

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