Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF CYPRUS	Assigned Ratings/Outlook: **BBB- /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:	25-11-2016 25-10-2019 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 25 October 2019

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

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Key Rating Drivers

1. Comparatively prosperous Cypriot economy displays vivid economic growth, which we expect to soften but remain resilient, buttressed by strong domestic demand and a sustained labor market recovery – net exports are likely to drag on growth going forward
2. While acknowledging government efforts, we note some risks that leave the economy vulnerable to shocks and constrain medium- to long-term growth, entailed by receding but high private sector debt, room for improvement in its business environment, higher dependence on few key industries, and weak productivity growth
3. Sovereign characterized by strong institutional conditions and sound policy-making; despite signs of some backtracking on the newly established foreclosure framework, we view policy continuity and strong commitment to prudent macro and fiscal policies as given more generally
4. Marked improvement of underlying fiscal metrics and progress in reducing non-performing exposures, which we expect to continue, resulting in a declining public debt ratio and gradually diminishing banking sector risks; however, government debt and NPE ratios are still very high, significant contingent liabilities
5. Irrespective of being distorted by presence of SPEs, external risks persist, mirrored by an elevated negative net international investment position and our expectation of a further widening current account deficit

Reasons for the Rating Decision

Creditreform Rating has raised its ratings on the Republic of Cyprus to “BBB-” from “BB+“. The upgrade reflects (i) vivid economic growth which evolved in line with our expectations, along with a sustained labor market recovery; and (ii) Cyprus’s strong fiscal performance, reflected by a marked improvement in underlying fiscal metrics, i.e. excluding one-offs related to the sale and wind-down process of Cyprus Cooperative Bank.

The outlook on the Republic of Cyprus remains positive, underpinned by our expectation that (i) the Cypriot economy will display robust economic growth over the next two years; (ii) labor market metrics will continue to improve; (iii) the public debt ratio will decline persistently on the back of resilient economic growth and large and recurring primary surpluses; and (iv) the workout of non-performing exposures (NPE) will make further progress.

Macroeconomic Performance

Cyprus’s macroeconomic performance builds upon relatively high levels of wealth and a strong growth momentum, accompanied by a pronounced labor market recovery. Still high private sector indebtedness weighs on the country’s macro profile, as do questions centered around the medium- to long-term sustainability of economic growth due to a higher dependence on few key industries, weak labor productivity, and the need for enhancing its business environment.

The Cypriot economy has continued its strong economic expansion. According to latest Eurostat data (2015 based chain linked volumes), Cyprus displayed still hefty real GDP growth of 4.1% in 2018, albeit slightly down from 4.4% a year before. Its economy thus not only continued to grow faster than the euro area as a whole (2018: 1.9%), which it has outpaced since 2015 when it reverted to growth – Cyprus also ranks among the most dynamically growing economies in Europe, with an annual average of 4.6% in 2015-18.

Last year’s growth was largely driven by private consumption, which expanded by 3.3% (2017: 4.5%), thereby contributing 2.2 p.p. to economic growth. Vivid household spending came mainly on the back of vigorous employment growth, while wages increased only moderately, partly due to remaining slack in the labor market. Hence, consumption took over from gross fixed capital investment as the economy’s key growth driver.

After two years of stellar performance, posting at 48.9 and 24.1% in 2016 and 2017 respectively, investment growth turned negative, dropping by 6.6% and detracting 1.4 p.p. from GDP growth in 2018. Volatility in gross fixed capital formation is mainly linked to SPEs and their de-/registration activities associated with transport equipment (i.e. shipping). Also, as was mentioned by the Central Bank of Cyprus (CBOC), other one-offs such as the bankruptcy of Cobalt Air, implying the termination of aircraft leasing contracts, had an adverse impact. Accordingly, transport equipment plummeted by 55.1% in volume terms, and from 6.0 to 2.5% of GDP in 2017-18 (Eurostat data). By contrast, investment activity was aided by construction projects geared towards tourism and residential construction, partly associated with the Citizenship program; total construction investment rose briskly from 9.0 to 10.5% of GDP.

SPE activity also blurred readings on real export growth, as exports of goods leapt by 31.8% on the year, leading to a 4.6% increase in exports of goods and services (Eurostat data). Imports grew less than exports, so that net exports supported growth in 2018 (+1.6 p.p. GDP). That being said, export growth fell when adjusting for the SPE impact, mainly due to declining financial services exports.

Following thriving economic activity, Cypriot per capita incomes have shown an equally remarkable rebound. After having dwindled from USD 36,411 to 32,597 between 2008 and 2014, GDP per capita surged to USD 39,987 in 2018, corresponding to an increase of 22.7% (IMF estimates, in PPP terms). Against this backdrop, the Cypriot economy has gained significant momentum in terms of convergence with EU levels over the recent years, as GDP p.c. has climbed from 87 to 93% of the EU-28 in 2014-18 – even outstripping Italy on that account (2018: 92%). We assess positively that Cyprus' per capita income stands well above the median income level of our A-rated sovereigns (USD 35,939).

Economic prospects remain favorable, and we pencil in real GDP growth of 3.0% in 2019 and 2.8% in 2020. The data outturn in the first half of the year was constructive in this respect, with yearly real GDP growth rates coming in at 3.4 and 3.2% in the first and second quarter respectively (EA-19: 1.3 and 1.2% in Q1 and Q2). Quarterly national accounts underscore our view that economic activity will level off further, but remain resilient and surpass euro area growth, propelled by strong domestic demand and a sustained labor market recovery, whereas net exports are likely to pare back.

We thus expect net exports to weigh on economic activity, as export growth is dampened by the slowdown in global growth and weakening external demand from the euro area, amidst external crosscurrents such as uncertainties engendered by fears of a disorderly Brexit and rising protectionism, although we have seen some signs of de-escalation in the US-China trade dispute more recently. Furthermore, we assume slower growth in tourist arrivals and revenues from tourism, curtailed by increasing competition from Turkey, Egypt, and Tunisia, and the closing of some airlines servicing the island. To be sure, the number of tourist arrivals climbed to a new record high of 3.94mn in 2018. However, growth in tourist inflows abated throughout 2018 and grew by 7.8%, almost half of the growth rate witnessed in 2017 (14.6%). This year, the sturdy growth of tourism inflows and related expenditure came to halt, with the cumulative number of arrivals virtually stagnating in the first nine months (+0.6%). At the same time, import growth should be supported by strong domestic demand.

In this vein, Cypriot growth will increasingly rely on domestic factors, with investment likely to play a prominent role. We expect investment activity to post solid growth, with several new tourism-, transport-, and infrastructure-related projects upcoming, e.g. marinas, a casino resort, and the University of Cyprus. Quarterly national accounts and building permission data corroborate our view that investment will particularly be aided by construction. While total construction investment surpassed last year's levels by 15.1 and 20.4% in Q1 and Q2 respectively, authorized building permits went up by 11.9% in 2018 and jumped by 52.1% y-o-y in the first half of 2019 (as measured by area in m^2). EU funding is also likely to support investment going forward. According to latest EU Cohesion data, financial funds allocated to selected projects leapt from around EUR 0.51 in 2017 via EUR 0.99bn (2018) to

EUR 1.06bn in June 2019, equating to an increase of 43 to 91% of planned investment. Latest survey data on capacity utilization in the industrial sector and upbeat business confidence is also consistent with a sustained expansion in investment. Capacity utilization was up from 61.8% in 3Q18 to 64.2% in this year's third quarter (2008-18 average: 59.3%). Also, Eurostat's construction confidence indicator stands at its highest level since 2008.

Private consumption is set to remain supportive to Cyprus's economic expansion, as further improving labor market conditions, rising wages, and subdued inflation create a favorable backdrop for household spending. Consumer sentiment also hints at robust private consumption. The consumer confidence indicator remained at elevated levels and has caught up more recently, after having weakened since the beginning of last year. Having said this, we foresee that consumption spending will be held back by the introduction of National Health System contributions and higher contributions rates to the Social Insurance Fund, somewhat denting real disposable income. Moreover, in the context of the newly introduced Estia scheme, which is designed to facilitate the workout of non-performing loans collateralized with primary residences, consumers are likely to be more inclined to repay outstanding debt and cut back on consumption.

The Cypriot labor market continues to recover strongly, with unemployment declining rapidly amid growing employment and rising labor market participation. The annual unemployment rate (LFS) stood at 8.4% in 2018, as compared to 11.1% in 2017. Higher frequency data confirm that unemployment follows a descending path. In the first quarter of 2019, the quarterly average (LFS, s.a.) stood slightly below the euro area average (CY: 7.5, EA-19: 7.7%), and declined further to 7.3% of the active population in 2Q19. Yet, unemployment among young people neither in employment nor in education and training is still pervasive (NEET unemployment rate 2Q19, s.a.: 14.3%), but clearly follows a downward trajectory; the same holds for still elevated youth unemployment more generally (2Q19: 16.6%). Falling unemployment is concomitant to extraordinarily strong employment growth. In 2018, Cyprus exhibited annual employment growth of 4.0%, the second fastest in the EU-28. Employment climbed to a new historical high at 0,429m, having increased by a yearly rate of at least 3.1% over twelve consecutive quarters. The labor participation rate has persistently risen since reaching its trough in 1Q16, amounting to 76.0% in the first quarter of 2019 (1Q18: 74.4%) and outperforming other economies with recovering labor markets such as Portugal, Spain, and Greece. The EU's social scoreboard gives a mixed picture, as Cyprus's labor market shows some weaknesses or critical developments along all three dimensions, while labor market dynamics appears to be the weakest area.

Meanwhile, some risks that leave the economy vulnerable to shocks and may constrain medium- to long-term growth remain in place. Above all, the challenge of very high private sector debt persists, limiting the risk resilience of non-financial corporations (NFCs) and households alike. As highlighted by Eurostat consolidated financial sector accounts, Cypriot private debt was the second highest in the EU-28 (behind Luxembourg). Although household finances have improved significantly over the last five years, with debt dipping below 100% of GDP for the first time since 2007, Cypriot households remain heavily indebted. Household debt equaled 98.9% of GDP in 2018, down from 107.2% in 2017. Likewise, NFC debt is among the highest in the EU28, totaling 194.8% of GDP in 2018, after 208% in 2017.

It has to be emphasized that NFC debt is still found to be high when excluding SPE-related debt. According to CBOC, NFC debt accounted for 118.2% of GDP in the fourth quarter of 2018, down from 128.9% in 4Q17.

We note that EU Commission estimates put Cyprus's potential growth at levels above the euro area and other former program countries. For 2019 and 2020, trend growth is forecast to increase from 1.9% in 2018 to 2.1% in 2019 and 2020 respectively. Notwithstanding, it may be worth considering the sustainability of medium- to long-term growth, as the pronounced recovery observed over the recent years was somewhat skewed towards tourism, construction, as well as financial and business services related to SPE activities. These activities may be subject to elevated volatility going forward, and may have limited positive knock-on effects on labor productivity in the medium to long term.

Against this background, we find that labor productivity growth has been rather anemic. As highlighted by Eurostat data, in 2018 real labor productivity per hour worked stood only 1.8% above the level of 2015, one of the lowest readings among the euro area economies (EA-19: 2.8%). As a corollary, nominal labor productivity per hour worked as a percentage of the EU total has been stagnating, posting at 76.3% last year, virtually the same as in 2015 (76.2%).

What is more, the business environment may act as a drag on medium- to long-term growth going forward. According to the Doing Business Report, Cyprus has ample room to improve its business environment, mirrored by a weak rank 57, among the weakest readings in the EU-28 and EA-19. In this vein, the World Bank attests a very poor performance as regards dealing with construction permits (rank 126/190), registering property (94), and enforcing contracts (138). The latest edition of the World Economic Forum's Global Competitiveness Report also points to considerable catching-up potential. As measured by the GCI 4.0, Cyprus takes on a rank 44 (same as in 2018), among the lowest-ranked economies in the EU-28, and second-to-last in the euro area.

As of now, however, we do not find that deteriorating competitiveness is an issue. Cyprus's global export market share has been stable over last five years (2018: 0.06%), while the important services export market share hovers at around 0.20%. Concerning its cost competitiveness, we expect real unit labor costs (ULC) to remain broadly unchanged. Last year, real ULC continued to evolve more favorably than in Cyprus's main trading partners and the euro area, as broadly unchanged labor productivity per person employed was accompanied by declining real compensation per employee. Drawing on AMECO data, real ULC decreased by 1.4 and 2.9% as compared to the year before and 2015 respectively, mainly owing to falling real wage growth.

Institutional Structure

Our credit assessment continues to reflect the strong institutional framework, aided by the high degree of ownership, as sound policy-making has been closely aligned with policies recommended by the EU and the IMF. The sovereign draws considerable benefits from its EU membership, involving financial support via EU funds and the adoption of common

standards and rules. With regard to the country's EMU membership, we believe that advantages related to the common currency, namely broad and deep capital markets and the euro's reserve currency status, are broadly balanced by the loss of monetary flexibility. We note that price levels, MFI interest rates, and wage developments have not been well-synchronized with the euro area as a whole

The latest vintage of the World Bank's Worldwide Governance Indicators (WGIs), published in September, confirms our view that accelerating the structural reform momentum is a key priority, and that steadfast efforts to address two areas of concern are needed, namely the comparatively inefficient judicial system and still elevated levels of corruption. As measured by the WGIs, our preferred measure of institutional quality, the sovereign continues to underperform on all the WGIs we assess as compared to the respective euro area median. We must, however, emphasize that Cyprus's WGI scores are broadly aligned with the median of our A-rated universe. With regard to the perception of the quality of policy formulation and implementation, Cyprus takes the 47th place out of 209 economies (EA-19: rank 35). We also believe there is ample room to improve on outcomes of the justice system, as reflected by a mediocre rank 51 as compared to a median euro area rank 32. As regards the effectiveness of the justice system, we observe that Cyprus remains among the worst performers in the EU Justice Scoreboard. As highlighted by the 2019 edition, the number of pending cases is very high, and the time needed in Cyprus to resolve civil, commercial, administrative and other similar cases is not only the longest in the EU, but has also increased since 2010. Moreover, the WGI control of corruption rank 55 (EA-19: rank 41/209) suggests that state capture by elites and private interests might be more prevalent than in other euro area countries, and public power may be exercised for private gain to a somewhat larger extent. According to the Council of Europe anti-corruption body GRECO, Cyprus is among the countries with the highest number of non-implemented (6) or only partially implemented (8) recommendations.

At the same time, authorities have begun embarking on several measures to improve efficiency in the public sector. Draft laws geared towards implementing adequate civil servant appraisal systems were tabled this October, and state-owned enterprises (SOEs) shall prepare a mid-term financial framework as of 2020. While we have seen tepid progress on the local government reform, policy-makers sent the Communities Bill for legal vetting in June 2019, envisioning the creation of 37 local clusters which should provide central civil services. To generate higher efficiency in governance, the sovereign established three new ministries, namely the Ministry for Shipping (Mar-18), the Ministry for Tourism (Jan-19), and the Ministry of Innovation and Digital Policy (Sep-19), which also points to key government priorities going forward. Additionally, the government envisaged stepping up efforts to tackle aggressive tax planning in 2020.

We observe that the implementation of the healthcare reform, which aims at enhancing the resilience of the healthcare sector and access to quality healthcare, has made palpable progress, as the National Health System (NHS) became operational in June this year, while full implementation (phase II) is foreseen for June 2020. Meanwhile, work on reforming the justice system and combating corruption remains tedious. While the introduction of an e-

justice system is facing delays, the appointment of additional judges to accelerate the reduction of the backlog of cases is underway, as the recruitment procedure for 35 new judges is ongoing. Measures to modernize civil procedure provisions, specialize courts, and enforce judgements more strictly have been embraced, with respective bills being forwarded to the Council of Ministers or the House of Representatives. Bills for the establishment of a training school for judges and for the expansion of the scale jurisdiction of the District Court judges and the Senior District Court judges in order to increase flexibility are pending before the House of Representatives.

For now, a reunification appears elusive, with the debate having stalled and the UN stating that the two sides were unable to agree on common grounds which would form the basis of new talks. We also took notice of resurfacing tensions with Turkey over oil- and gas-drilling activities more recently.

Fiscal Sustainability

Risks to fiscal sustainability continue to represent one of the sovereign's main weaknesses. Despite a marked improvement of underlying fiscal metrics and progress in reducing non-performing exposures, general government debt levels and stocks of NPEs remain very high, and the banking sector continues to entail significant liability risks for public finances.

We have witnessed a strong underlying fiscal performance and significant efforts in fiscal consolidation over the past years. Last year, Cyprus's fiscal consolidation path experienced a temporary setback as the headline balance turned from a surplus into a deficit, accounting for 4.4% of GDP. However, the huge discrepancy between the eventual outturn and the targeted surplus of 2.9% in the Draft Budget 2019 was entirely due to the sale and wind-down process of Cyprus Cooperative Bank Ltd (henceforth CCB). Excluding the sizable one-off related to the CCB operation, standing for roughly EUR 1.685bn or 8.0% of GDP, the underlying budget surplus increased from 1.7 to 3.6% of GDP in 2017-18, eventually over-achieving the budget target for 2018. The respective primary balance increased from 4.2% of GDP in 2017 to a remarkable 6.0% last year – the highest reading in the EU-28.

Drawing on latest Eurostat government finance statistics, the marked improvement of underlying fiscal metrics was mainly buttressed by general government revenues which increased by a strong 7.2% (39.2% of GDP) on the back of brisk tax revenues and social benefits. While net social contributions jumped by 8.0%, the 2018 VAT receipts rose by 12.8%, supported by the favorable tourism development and robust economic activity. By the same token, taxes on income and wealth edged up by 4.6%, mainly due to the strong corporate income and capital tax intake. On the spending side, the one-off lead to surging expenditure, from 36.9 to 43.6% of GDP in 2017-18. Excluding one-offs, general government outlays rose by a moderate 2.3% amid higher compensation for employees and interest payments. These items increased by 5.0 and 0.3% in volume terms, displaying slower growth than nominal GDP, thus decreasing to 11.7 and 2.4% of GDP respectively.

Looking forward, Cypriot public finances are very likely to remain in good shape, presumably posting headline surpluses of 3.5% in 2019 and 2.6% 2020. We expect that robust economic activity will result in solid tax gains, whilst general government revenues are likely

to be boosted by higher social security contributions given the introduction of the NHS (as of Mar-19), increases in social security contributions (as of Jan-19), and the ongoing labor market recovery. On the expenditure side, outlays are about to increase on account of NHS social payments and employer contributions, higher health expenditure, costs associated with the Estia scheme, COLA provisions and, in particular, higher public wages owing to the gradual reversal of wage cuts which were put in place during the crises. Revenues will also prospectively outstrip government expenditure next year. Whilst robust economic activity is likely to cater for persistently solid tax receipts and interest expenses should recede, the continuation of the gradual abolition of wage cuts, a drop in property income related to receipts stemming from hydrocarbon reserves, and further increasing social payments should translate into a lower surplus. The Ministry of Finance reckons that the Health Insurance Organization will have a positive impact of approx. 0.5% of GDP in 2019 and be fiscally neutral next year.

Cyprus's public debt ratio is set to fall below 90% of GDP by 2020 and decline rapidly over the medium term, supported by strong nominal GDP growth and sustained though gradually decreasing primary surpluses which will remain among the highest in the euro area. We nevertheless note that general government debt remains high for now, in part due to the transitory setback related to the CCB operation, with gross debt spiking from 93.9 to 100.6% of GDP in 2017-18, representing one of the highest readings in Europe.

As we do not factor in potential proceeds from KEPIDES, there certainly are some upside risks to the fiscal outlook. The same applies to proceeds from privatizing SOEs, although we view it as unlikely that privatization plans will progress any time soon. Furthermore, authorities have tended to formulate rather conservative targets more recently, which were eventually overachieved.

Gradually declining interest costs and prudent debt management should increasingly mitigate fiscal risks. Although interest outlays are still relatively high from a European perspective, interest expenditure is likely to continue on its downward trajectory. In 2018, interest outlays equated to 6.2% of general government revenue, down from 6.6% in the year before, and 1.9 p.p. lower than in 2015. In addition, authorities have taken advantage of the favorable interest rate environment, as the weighted average maturity of marketable debt rose from 2.7y in 2012 via 4.9y in 2016 to 6.4y in May 2019, while the costs of public debt stood at a low 2.2% (as of Sep-19), broadly unchanged as compared to 2016 and 2017. Long-term government bond yields have dwindled to historically low levels, and display an extremely low Bund spread. Whereas the Bund spread declined to 107bp in September 2019 (Sep-18: 164bp), the long-term bond yield plummeted from 2.01 to 0.48% in the year to last September.

Nevertheless, a plethora of downside risks to Cyprus's fiscal consolidation requires close attention. Standing out in particular are uncertainties concerning the pending decision of the Supreme Court, after the government appealed the Constitutional Court's ruling stating that the Reduction of Salaries and Pensions of Public Service Officials, Employers and Pensioners of the Public Sector Law dating back to 2012 was unconstitutional. Further risks include further mounting pressure from public wages, cost overruns at public hospitals,

and doubts regarding the sustainability of vivid tax revenues, which may come down in the wake of a cyclical downturn.

What is more, public guarantees have surged in the aftermath of the CCB operation and the Ministry of Finance expects them to decline only moderately to 20.9 and 19.4% of GDP in 2019 and 2020 respectively, of which 11.8 and 10.6% of GDP are linked to the financial sector (2017: 8.7%). Adding to this, the Cypriot banking sector remains an imminent source of significant contingent liability risks. Despite the demise of CCB, the banking sector is very large, totaling 279% of GDP, and highly concentrated, with Cyprus's three largest banks accounting for roughly three-fourth of total deposits. To be sure, banking sector metrics on capital buffers and profitability have improved since our last review. According to EBA data, the CET 1 ratio rose from 13.2% in last year's second quarter to 15.7% in 2Q19, somewhat above the EU-28 average of 14.6%. Cypriot banks appear to have returned to profitability, with return on assets also standing above the EU average (2Q19: 0.9 vs. 0.5%), although the net interest margin declined further, inching down from 2.4 to 2.1% in the year to the second quarter of 2019 (EBA data). Still, the very high stock of NPEs remains one of Cyprus's major weaknesses, exhibiting the second highest reading in the EU-28, regardless of the significant effort made. Drawing on more detailed CBOC data up to May 2019, total NPEs plummeted to 31.0% as compared to 41.4% a year before, mainly thanks to the CCB operation and the sale of an NPE portfolio to Apollo Global Management LLC. NFCs and households account for roughly half of the NPE stock each, with the respective NPE ratios coming in at 31.9 and 37.7% in May 2019 (May-18: 46.5 and 52.0%).

Our baseline scenario assumes that the NPE resolution will make further progress, not least due to crucial measures that have been put in place to speed up the workout of NPEs, thus mitigating financial and concurrently fiscal risks. While landmark reforms to foster NPE resolution and improve payment discipline were implemented in July 2018, the Estia scheme came into force this September, and applicants are required to apply by 15 November 2019. We are, however, concerned about signs of backtracking on the newly established foreclosure framework. In August 2019, new amendments passed Parliament, possibly hampering the property auction process and the banking sector's ability to resolve the high stock of NPEs. Yet, President Anastasiades vetoed the respective bills which will be reviewed by the Supreme Court. As we understand, the Supreme Court will not decide on the appeal before March 2020.

Foreign Exposure

Vulnerabilities stemming from Cyprus's external position persist, although we observe a gradual improvement in the country's highly negative net international investment position (NIIP).

Latest balance of payment data signals that the headline current account deficit decreased to 4.4% of GDP in 2018, having deteriorated from 4.2 to 5.1% of GDP in 2016-17; the deficit now equals its 10-year average. The improvement was buttressed by the narrowing trade in goods deficit (+2.9 p.p. GDP), thus overcompensating the worsening trade in services and primary income balances (-1.7 and -0.5 p.p. respectively). It has to be highlighted that headline figures are traditionally distorted by the strong presence of SPEs. Judging by CBOB

data dating back to June, according to which the adjusted current account deficit actually increased (then from 3.1 to 4.5% of GDP in 2017-18), and assuming that the basic pattern remained in place, the underlying current account should have widened.

Going forward, Cyprus's large current account deficit should remain in place. We expect that its deficit will somewhat increase in the near term, as softer euro area growth and the gloomy outlook for growth in international trade are likely to compress export growth, and imports should increase on the back of robust domestic demand.

Hence, the NIIP should remain highly negative and continue to decline gradually. Although having come down more recently, Cyprus's NIIP is one of the most negative in the EU-28, implying elevated external funding needs. Being driven by significant financial liabilities related to the purchase of ships, translating into highly negative net other investment (2018: -174.2% of GDP) which is only partly compensated by net direct and portfolio investment (34.8 and 10.8% of GDP), the NIIP fell from -129.8 to -123.1% of GDP in 2017-18. Adjusting for the impact of SPEs with limited links to the domestic economy, the underlying NIIP drops to still high -38.2% of GDP, albeit down from -43.0% of GDP (CBOC June data).

Rating Outlook and Sensitivity

Our Rating outlook on Cyprus's sovereign ratings 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 the sovereign's credit ratings if medium-term real GDP growth evolves as expected and the labor market continues to recover, if NPE resolution is making substantial headway, if contingent liabilities are materially reduced, and/or if we see the public debt ratio sustainably falling below prudential thresholds. Further upward pressure could result from renewed momentum in structural reform.

While the positive outlook indicates that a downgrade is rather unlikely at the current juncture, downward pressure on the outlook or the rating could arise if medium-term growth declines significantly, with Brexit being a key risk in this respect. Irrespective of the fact that some corporates may relocate their operations to Cyprus, its economy may experience noticeable effects in the wake of a hard Brexit. This is indicated by our Brexit Risk Indicator, according to which Cyprus is among those countries most heavily exposed to UK-related trade and capital flows in the EU-27 (BRI: 3.6, EU-27 median 2.0; see "What if... – Consequences of a hard Brexit for the EU-27 states"). If we observe significant fiscal slippages or a reversal of the downward trending debt-to-GDP ratio, and/or the NPE stock stagnates at the current high levels, we could also consider revising our outlook or the rating.

Primary Analyst
Wolfgang Lauer
Sovereign Credit Analyst
w.lauer@creditreform-rating.de
+49 2131 109 3865

Chair Person
Benjamin Mohr
Head of Sovereign Ratings
b.mohr@creditreform-rating.de
+49 2131 109 5172

Ratings*

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

*) Unsolicited

Economic Data

	2014	2015	2016	2017	2018	2019e	2020e
Real GDP growth	-1.9	3.4	6.7	4.4	4.1	3.0	2.8
GDP per capita (PPP, USD)	32,597	34,019	35,969	37,994	39,987	41,407	42,956
HICP inflation rate, y-o-y change	-0.3	-1.5	-1.2	0.7	0.8	0.7	1.5
Default history (years since default)	1	2	3	4	5	6	7
Life expectancy at birth (years)	82.3	81.8	82.7	82.2	n.a.	n.a.	n.a.
Fiscal balance/GDP	-8.7	-1.0	0.1	1.7	-4.4	3.5	2.6
Current account balance/GDP	-4.1	-0.4	-4.2	-5.1	-4.4	n.a.	n.a.
External debt/GDP	1149.4	1262.8	1147.8	1074.5	989.7	n.a.	n.a.

Source: International Monetary Fund, Eurostat, Central Bank of Cyprus, own estimates

Appendix

Rating History

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

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. The Central Bank of Cyprus (CBOC) and the Ministry of Finance (MOF) participated in the credit rating process as both authorities 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 CBOC and MOF during their review. However, 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 used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, Central Bank of Cyprus, Republic of Cyprus - Ministry of Finance, Public Debt Management Office, Statistical Service of Cyprus (Cystat).

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

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

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Creditreform Rating AG

Creditreform Rating AG
Hellersbergstrasse 11
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Prof. Dr. Helmut Rödl
HRB 10522, Amtsgericht Neuss