Republic of Cyprus
Rating Report

SCOPE **BBB-** STABLE OUTLOOK

Credit strengths

- Strong growth potential
- Solid fiscal consolidation prospects and improved debt profile
- Structural reform momentum

Credit challenges

- Externally dependent, concentrated economy
- Banking sector vulnerabilities
- High public and private debt

Rating rationale:

Strong growth potential: Cyprus benefits from its strong medium-term growth potential which has underpinned one of the highest growth rates in the euro area. Growth is supported by sound macro-economic policies, improving labour market conditions as well as foreign-financed investment in important sectors.

Solid fiscal consolidation prospects: Cyprus has a good record of fiscal consolidation characterised by consistent fiscal surpluses, overachieving fiscal targets, and a steadily decline in public indebtedness pre-Covid. Renewed commitment to fiscal discipline and a robust growth outlook underpin a return to pre-crisis debt levels within the forecast horizon.

Sound structural reform momentum: Cyprus's stable and reform-oriented government has achieved considerable progress in implementing reforms to address imbalances in the economy following the 2012-13 crisis. We expect the government's reform agenda as part of its National Reform and Recovery and Resilience plans to have a positive impact on the economy.

Rating challenges include: i) a small, externally dependent and concentrated economy; ii) lingering though improving vulnerabilities in the banking sector; and iii) high public and private debt levels combined with large external imbalances. These factors increase Cyprus's sensitivity to shocks.

Cyprus's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	bbb+		0	BBB-
Public Finance Risk		25%	a		+1/3	
External Economic Risk		10%	c		-2/3	
Financial Stability Risk		10%	a+		-2/3	
ESG Risk	Environmental Risk	5%	bbb+		-1/3	
	Social Risk	5%	aa		0	
	Governance Risk	10%	bbb		-1/3	
Overall outcome		**bbb**		**+1**	**-2**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

Positive rating-change drivers

- Sustained strengthening of the banking sector
- Post-crisis fiscal performance improves, leading to a material decline in public debt stock
- Potential growth is raised sustainably

Negative rating-change drivers

- Medium-term growth prospects deteriorate substantially
- Fiscal outcomes are weaker than anticipated
- Banking sector fragilities re-emerge

Ratings and Outlook

Foreign and local currency

Long-term issuer rating	BBB-/Stable
Senior unsecured debt	BBB-/Stable
Short-term issuer rating	S-2/Stable

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Bloomberg: RESP SCOP

Domestic Economic Risks

- **Growth outlook:** After growing by 4.6% on average over 2015-19, Cyprus's GDP shrank by 5.2% in 2020. The contraction in Cypriot economic activity was milder than expected in view of its externally dependent economy, with a high reliance on tourism-related activities, and the government's strict containment measures. The government's effective and targeted measures to contain the spread of the virus, enhance the national health system and support firms and households played an important role in mitigating the economic effects of the crisis.

  We project growth to average 3.4% over 2021-26, reflecting the country's strong long-term growth potential of 2.6%. Growth will be supported by continued rollout of the vaccine, the implementation of the government's EUR 1.2bn (5.3% of GDP) Recovery and Resilience Plan, and gradual recovery in the tourism sector. Important downside risks remain however.

- **Inflation and monetary policy**: Following eleven consecutive months of negative headline inflation, HICP inflation turned positive in March 2021 and has since picked up substantially, averaging 3.5% in the six months to November 2021. Price increases were seen mostly in the transportation sector as well as in housing, water electricity, gas and other fuels due to rising international oil prices. Core inflation was more moderate at 1.5% on average over the same period.

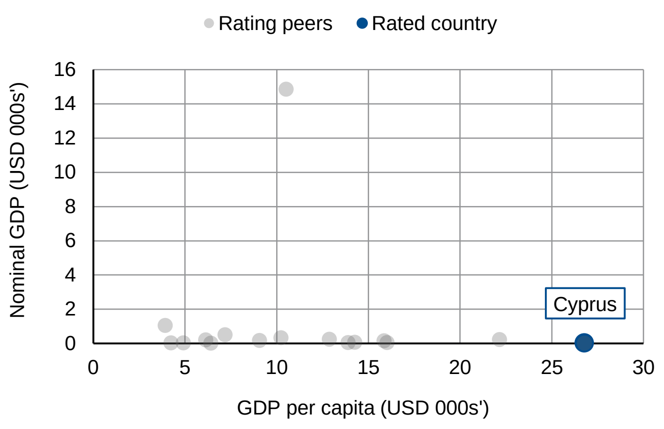
  We expect the ECB balance sheet to continue to expand under PEPP and/or other asset-purchases facilities though at a more moderate pace. This will provide continued support to debt capital markets. Policy rates should start increasing only after 2022.

- **Labour markets**: Labour markets have been affected but less severely than implied by the fall in output. Unemployment peaked at 9% in September 2020 and has since dropped to 6.6% as of October 2021, below pre-crisis levels. Similarly, we note that the employment exceeded 2019 levels in Q3 2021. The flexibility of labour markets in Cyprus and supportive fiscal measures contribute to the normalisation of labour conditions. The government's strategy of developing of new emerging sectors and reducing reliance on tourism, construction and real estate will require a reallocation of labour and upskilling the workforce.

Overview of Scope's qualitative assessments for Cyprus's *Domestic Economic Risks*

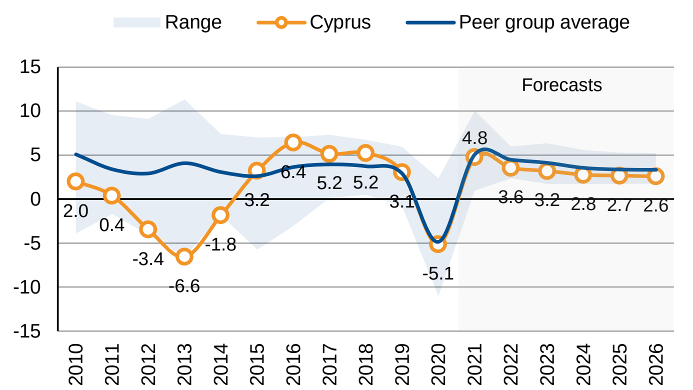
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Growth potential of the economy	Strong	+1/3	Strong growth potential supported by improving labour markets, rising income levels and foreign investments
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; accommodative policies adequately support the economy.
	Macro-economic stability and sustainability	Weak	-1/3	Economic structure exposed to volatility; long-term sustainability of growth reliant on foreign funding or external demand

Nominal GDP and GDP per capita, USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

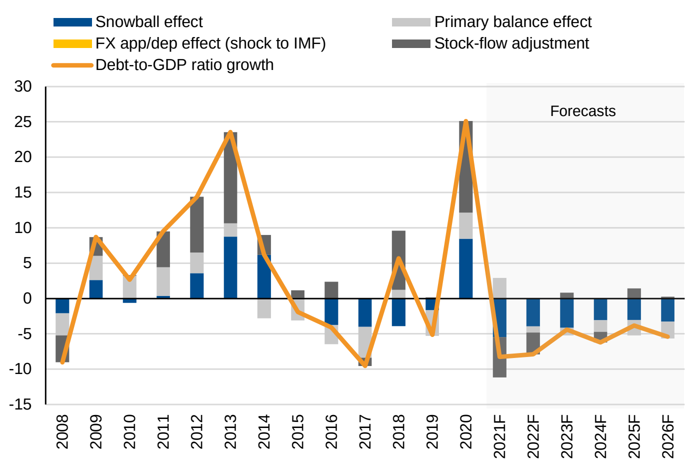
Public Finance Risks

- **Fiscal outlook**: The countercyclical fiscal policies of the Cypriot government in response to the Covid-19 crisis, while appropriate, have led to a substantial deterioration in the country's near-term fiscal fundamentals. The budget deficit reached 5.7% of GDP compared to a surplus of 2.5% of GDP in 2019, underpinned by forceful Covid-19 economic support measures. With the extension of support measures in 2021 worth around 4.1% of GDP, the budget balance is expected to improve slightly but remain at a deficit of 5.1% of GDP. The government's medium-term budgetary strategy aims at achieving a structurally balanced fiscal position. We expect the budgetary position to improve gradually in coming years with a return to budget surpluses by 2024.
- **Debt trajectory:** The combined impact of a marked deterioration in fiscal performance and the sharp contraction in GDP pushed the public debt-to-GDP ratio to 115% end 2020, up from 91% the year before and at an all-time high. This increase also reflects a substantial increase in Cyprus's cash buffer which stood at 15% of GDP at the end of 2020. Net debt recorded a more moderate increase of 11pps of GDP. A significant improvement in budgetary performance, strong growth and the expected reduction in the cash buffer will lead to a substantial decline in the debt-to-GDP ratio. We expect public debt to return to pre-pandemic levels by 2024 and reach 82% of GDP by 2026.
- **Debt profile and market access:** Cyprus benefits from a favourable debt profile supported by its pro-active debt management strategy. Cypriot public debt has a low share of short-term debt (1%), no foreign currency exposures, limited interest rate risks (71% of debt is fixed rate) and a long weighted average maturity of 7.8 years. The investor base has become less risky with the rising importance of central banks which held 21% of outstanding public debt. Cyprus is also benefitting from the highly accommodative policies of the ECB with the 10-year government bond yield currently at around 0.7%.

Overview of Scope's qualitative assessments for Cyprus's *Public Finance Risks*

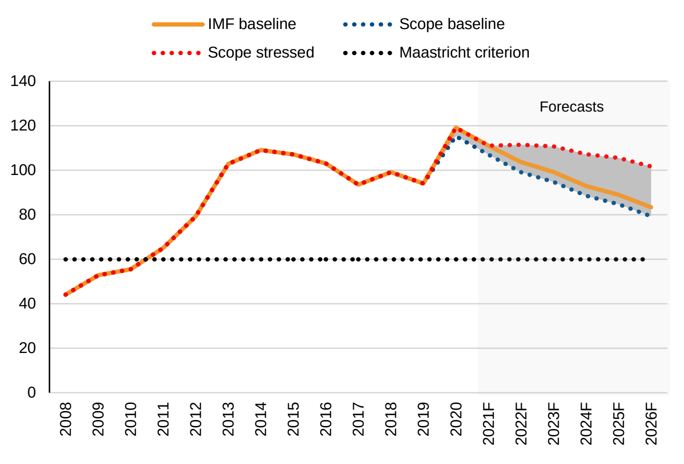
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Fiscal policy framework	Strong	+1/3	Good record of effective fiscal consolidation and overperforming fiscal targets
	Debt sustainability	Neutral	0	Elevated public debt; sharp increase in indebtedness due to Covid-19 crisis; medium term debt trajectory is steadily declining
	Debt profile and market access	Neutral	0	Declining interest payment burden, rising average maturity and improving investor base

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

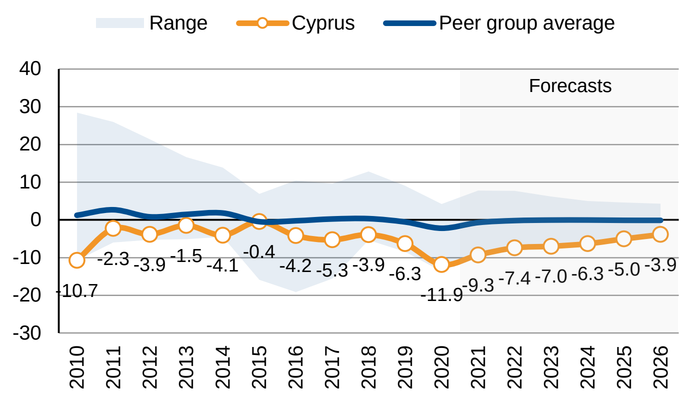
External Economic Risks

- **Current account:** Cyprus's current account is characterised by wide deficits driven by high levels of net goods imports which are only partly offset by high levels of net services exports. This reflects Cyprus's status as a tourism destination, financial service hub and as a resource constrained island state. The current account deficit widened substantially to -10.1% of GDP in 2020 due to the Covid-19 pandemic according to government estimates. The prevalence of Special Purpose Entities (SPEs) leads to significant distortions in its external statistics while having limited ties to the real economy. The 2020 current account balance excluding SPEs stood at -9.7% of GDP. We expect the current account balance to gradually improve in coming years as external demand recovers.
- **External position:** Cyprus's external position is weak. The net international investment position was very negative at -132% of GDP in Q3 2021 (-46.5% of GDP after adjustment for the impact of SPEs) which remains a source of vulnerability and warrants monitoring. Cyprus' external debt is high, at 854% of GDP in Q3 2021 (297% of GDP excluding SPEs) but has declined substantially in recent years, falling from the peak of 1259% of GDP in Q4 2015. The IMF assesses Cyprus's SPE-adjusted external position to be weaker than the level implied by medium-term fundamentals and desirable policies.
- **Resilience to shocks:** Euro area membership bolsters resilience to short-term shocks. As a small, open economy which is highly depending on foreign funding and foreign demand, Cyprus remains exposed to short-term external shocks. This, combined with the external vulnerabilities highlighted above presents a risk to the Cypriot economy.

Overview of Scope's qualitative assessments for Cyprus's *External Economic Risks*

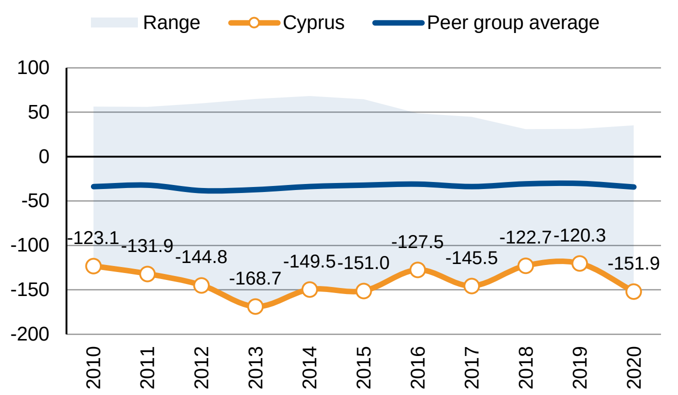
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
c	Current account resilience	Weak	-1/3	Consistent current account deficits with exports concentrated in a few key sectors
	External debt structure	Weak	-1/3	Large external debtor position and high external financing needs exacerbated by current account deficits
	Resilience to short-term shocks	Neutral	0	External imbalances are mitigated by euro area membership

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

Financial Stability Risks

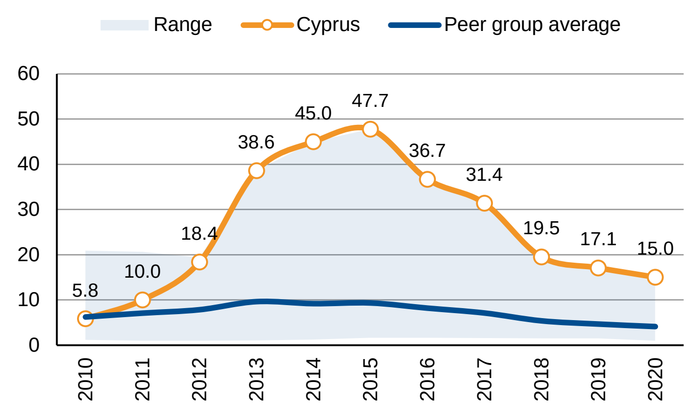
- **Banking sector:** The banking sector entering the Covid-19 crisis was on a positive path to consolidation with Cypriot credit institutions showing stronger capitalisation levels, improved asset quality and comfortable liquidity positions. The Covid-19 pandemic has tested the resilience of the sector, but the banking sector is weathering the crisis rather well. Capital positions remained strong with a CET1 ratio of 17.2% in June 2021. After a sizeable loss in 2020, the sector returned to a small profit in H1 2021 though profitability remains a challenge. Finally, the nonperforming exposure-to-gross loans ratio has declined substantially 17% in July 2021, down from 28% at the start of 2020 thanks to large sales and write-offs though important credit risks remain.
- **Private debt:** Private sector debt remains a weakness as more than 80% of bank loans are to highly leveraged households and SMEs. Household debt, at 91% of GDP in 2020, is the fourth highest in the EU after Denmark, the Netherlands, and Sweden. Similarly, nonfinancial corporate debt levels, although declining, remain very high at 261% of GDP, well above the EU average (140% of GDP).

  Particular attention should be paid to the household sector given its high levels of financial fragility. Cyprus is among the European countries whose household sector is the most vulnerable to unexpected shocks with 44.6% of households reporting their inability to meet an unexpected, required expense.
- **Financial imbalances:** Risks related to the real estate sector appear limited for now given only broad stability in residential prices in recent years. Cyprus is the European Union member state whose house price index has grown the least relative to 2015 levels (4.1% in June 2021 versus a euro area average increase of 32%). This reflects, in part, the difficulties experienced by the domestic banking sector which restricts the credit supply. Public authorities have implemented several macroprudential measures to limit financial stability risks including loan-to-value and debt service to income limits as well as capital buffers for other systemically important institutions.

Overview of Scope's qualitative assessments for Cyprus's *Financial Stability Risks*

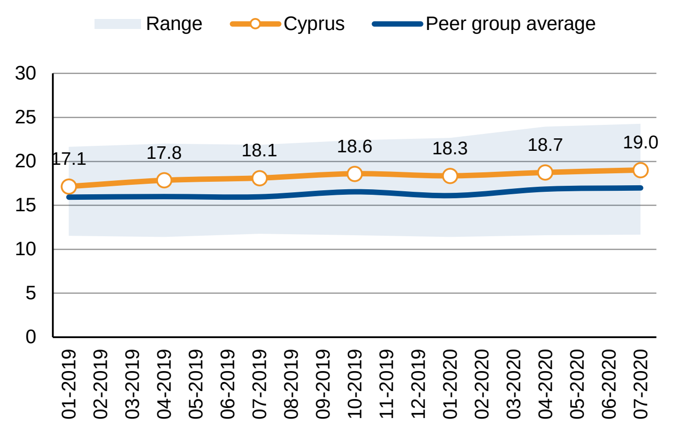
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Banking sector performance	Weak	-1/3	Poor asset quality and profitability pressures weigh on banking sector performance
	Banking sector oversight	Neutral	0	Effective oversight; recently reinforced AML/CFT and NPL resolution frameworks
	Financial imbalances	Weak	-1/3	Elevated private indebtedness and financial fragility of households pose risks

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

ESG Risks

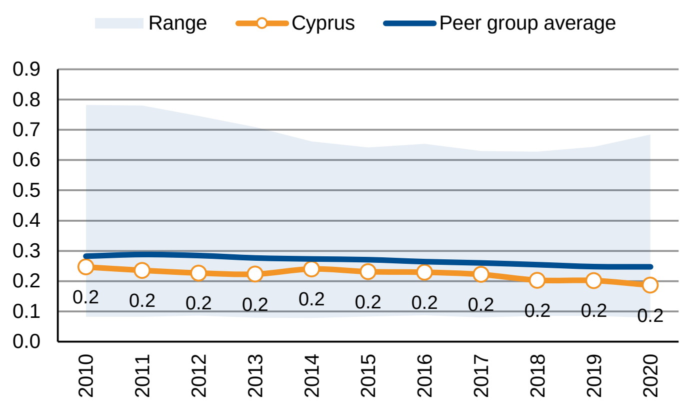
Environment: Cyprus is particularly vulnerable to the adverse effects of climate change due to its position as a small Mediterranean island state. Its economy is among the most carbon intensive in the EU in terms of CO² emissions per euro while emissions reduction has lagged that of other EU states with a 4.1% decrease since 2005, below the EU-wide reduction of 19% over the same period. The country's National Energy and Climate plan sets emission reduction targets of 21% compared to 2005, in line with the 24% target under the Effort Sharing Regulation when available flexibilities are taken into account. Climate plans include a long-term strategy for building renovation, projects aimed at developing a natural gas system, the rollout of a renewable energy roadmap, investments to encourage a shift towards green mobility and the introduction of a carbon tax.

- **Social**: Cyprus benefits from favourable demographics, with its old age dependency ratio currently among the lowest in the EU. Cyprus performs also relatively well in terms of poverty and income inequality relative to peers, both of which are on an improving trajectory. Cyprus has posted one of the strongest improvements among EU countries regarding the share of people at risk of poverty or social exclusion over the last five years (-7.6pps). Cyprus performs poorly in terms of education outcomes, with its PISA scores ranking consistently among the lowest EU performers despite spending more on education than other EU countries (5.4% of GDP versus a 4.7% EU average) while youth unemployment remains high.
- **Governance:** Cyprus scores better than peers on the World Bank's Worldwide Governance Indicators but underperforms the EU average. The president, Níkos Anastasiádis, was re-elected in 2018 for another 5-year term although with continued minority control over parliament following legislative elections in 2021. Geopolitical risks persist on the island, with a division of the country between Greek and Turkish speaking communities. Negotiations over the reunification of the country have been deadlocked since talks broke down in April 2021. Tensions between Cyprus, Greece, the EU and Turkey over competing claims to hydrocarbon reserves persist and have intensified.

Overview of Scope's qualitative assessments for Cyprus's *ESG Risks*

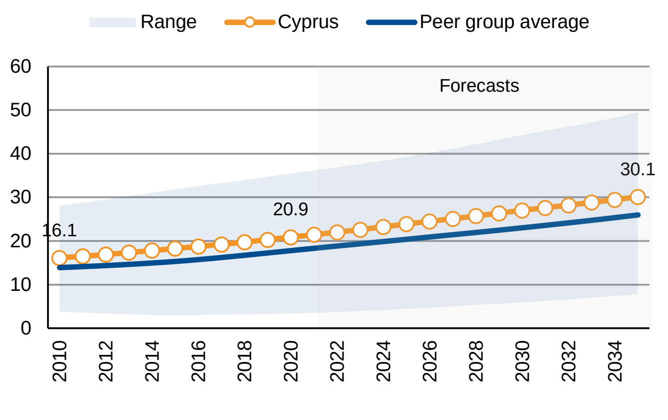
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental risks	Weak	-1/3	Elevated transition and resource risks; high mitigation costs due to geographical constraints and service-based economy
	Social risks	Neutral	0	Weak youth employment dynamics and gender equality; improving poverty and income inequality
	Institutional and political risks	Weak	-1/3	Lingering geopolitical tensions and limited progress on reunification talks

CO2 emissions per GDP, mtCO2e



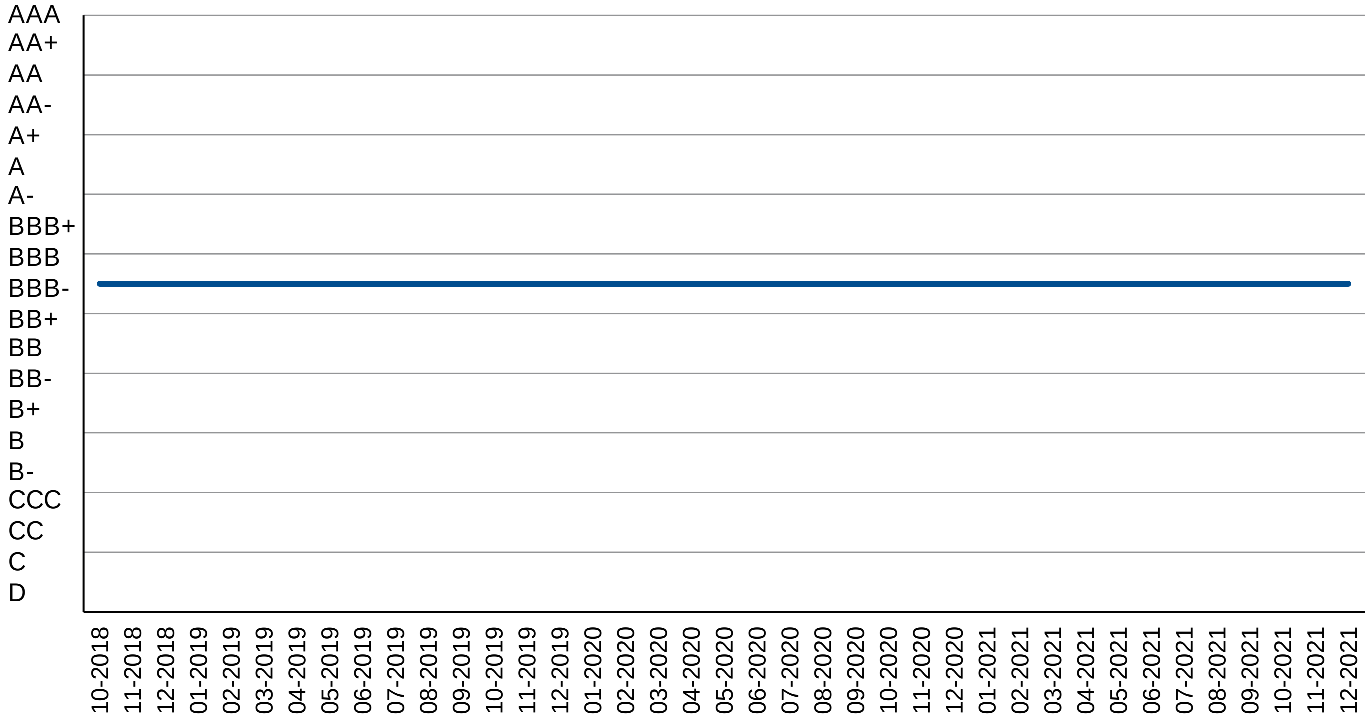
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard.

Peer group*
China
Croatia
Cyprus
Hungary
Portugal
Romania

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD 000s'	24.7	26.6	29.3	28.5	26.8	29.5	31.0	32.9
Nominal GDP, USD bn	20.9	22.7	25.3	25.0	23.8	26.5	28.3	30.4
Real growth, %[1]	6.4	5.2	5.2	3.1	-5.1	5.1	4.0	3.4
CPI inflation, %	-1.2	0.7	0.8	0.6	-1.1	1.7	1.1	1.2
Unemployment rate, %[1]	13.0	11.1	8.4	7.1	7.6	7.1	6.9	6.4
Public Finance Risk								
Public debt, % of GDP[1]	103.1	93.5	99.2	94.0	115.3	110.7	102.7	98.1
Interest payment, % of government revenue	6.5	6.1	5.7	5.3	5.0	5.2	4.9	4.1
Primary balance, % of GDP[1]	2.7	4.3	-1.2	3.6	-3.7	-2.9	0.9	1.1
External Economic Risk								
Current account balance, % of GDP	-4.2	-5.3	-3.9	-6.3	-11.9	-9.3	-7.4	-7.0
Total reserves, months of imports	0.3	0.2	0.2	0.4	0.4			
NIIP, % of GDP	-127.5	-145.5	-122.7	-120.3	-151.9			
Financial Stability Risk								
NPL ratio, % of total loans	36.7	31.4	-	-	-	-	-	-
Tier 1 ratio, % of risk weighted assets	16.4	15.4	16.4	18.6	19.2	18.8	-	-
Credit to private sector, % of GDP	217.6	193.6	137.7	112.0	114.3	-	-	-
ESG Risk								
CO^2 per EUR 1,000 of GDP, $mtCO^2e$	229.2	222.0	202.9	201.8	186.3	-	-	-
Income quintile share ratio (S80/S20), x	-	-	-	-	-	-	-	-
Labour force participation rate, %	72.2	72.8	74.1	74.8	-	-	-	-
Old age dependency ratio, %	18.7	19.2	19.7	20.3	20.9	21.4	22.0	22.6
Composite governance indicator[2]	0.9	0.9	0.8	0.8	1.1	-	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 07 January 2022	45.3

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