Republic of Cyprus
Rating Report

SCOPE BBB STABLE OUTLOOK

Credit strengths	Credit challenges
• Strong growth potential • Prudent fiscal management and favourable debt trajectory • Structural reform momentum	• 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 macroeconomic policies, improving labour market conditions, as well as foreign-financed investment in important, high growth sectors.

Solid fiscal consolidation prospects: Cyprus has a good fiscal consolidation record characterised by consistent fiscal surpluses pre-Covid-19 crisis, overachieving fiscal targets, and marked debt reduction. Renewed commitment to fiscal discipline, a robust growth outlook and sound fiscal performance underpin a very favourable debt trajectory.

Sound structural reform momentum: Cyprus's has achieved considerable progress in implementing reforms to address imbalances in the economy following the 2012-13 crisis. Good progress on the government's reform agenda and under its National Reform and Recovery and Resilience plans will address structural challenges and enhance economic resilience.

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		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bbb+	EUR [+1]	0	BBB
Public Finance Risk		20%	aaa		+1/3	
External Economic Risk		10%	c		-3/3	
Financial Stability Risk		10%	aa-		-2/3	
ESG Risk	Environmental Factors	5%	bbb+		-1/3	
	Social Factors	7.5%	a		0	
	Governance Factors	12.5%	bbb		-1/3	
Indicative outcome			**a-**		**-2**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment 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.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced.

Positive rating-change drivers	Negative rating-change drivers
• Sustained fiscal consolidation • Further reduction in banking sector vulnerabilities • Reduced sensitivity to external shocks	• Growth outlook deteriorates substantially • Fiscal fundamentals weaken significantly • Banking sector fragilities re-emerge

Ratings and Outlook

Foreign currency

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

Local currency

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

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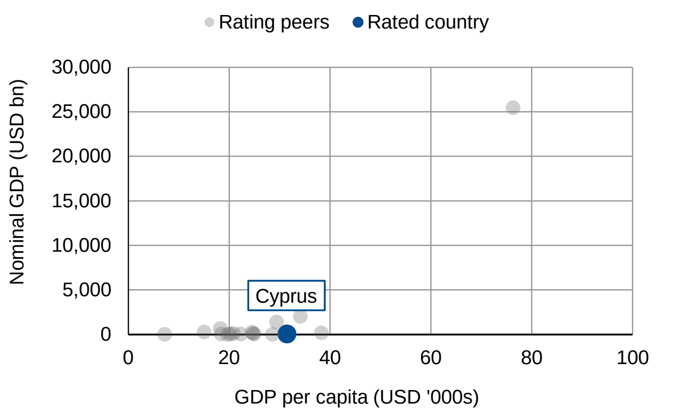
Domestic Economic Risks

- **Growth outlook:** The Cypriot economy has been remarkably outperforming expectations growing by 5.6% in 2022 despite an adverse external environment. This is largely due to the faster-than-expected recovery in tourism and sustained expansion in exports of other services, notably business services and IT, while the rapid increase in private consumption benefitted from the fast reactivation of the economy. The economy proved resilient to the Russia-Ukraine crisis, especially given its initial reliance on Russian and Ukrainian tourists as it diversified to other markets. Moreover, strong growth in ICT, financial and professional services points to greater diversification of the economy. Medium-term growth will be supported by the EUR 1.2bn (5.2% of GDP) Recovery and Resilience plan of which EUR 20% has been disbursed so far. We project growth to moderate to 2.5% in 2023 and then average around 2.9% thereafter.
- **Inflation and monetary policy:** After peaking at 10.6% in July 2022, HICP inflation declined to 3.9% in April 2023, among the lowest in the EU and well below the 9% EU average. Inflationary pressures should gradually moderate as energy prices and supply chain disruptions normalise. The ECB has rapidly tightened monetary policies to tame price pressures, hiking rates for a total 375bps since July 2022, to a deposit facility rate of 3.25% while halting net asset purchases.
- **Labour markets:** Labour market recovery has been uneven though with some recent improvements. Unemployment in monthly seasonally adjusted terms improved in recent months, reaching 6.8% in March 2023. We expect it to average 6.5% in 2023, after 6.8% in 2022 and then gradually decline to 6% by 2028. Youth unemployment remains high, although it has more than halved since 2013, falling to 19.2% in Q4 2022. In August 2022, the government agreed to implement a minimum wage at EUR 885 from January 2023 which rises to EUR 940 after the first six months of employment in June. This, combined with the automatic wage indexation mechanism should help support living standards among households.

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

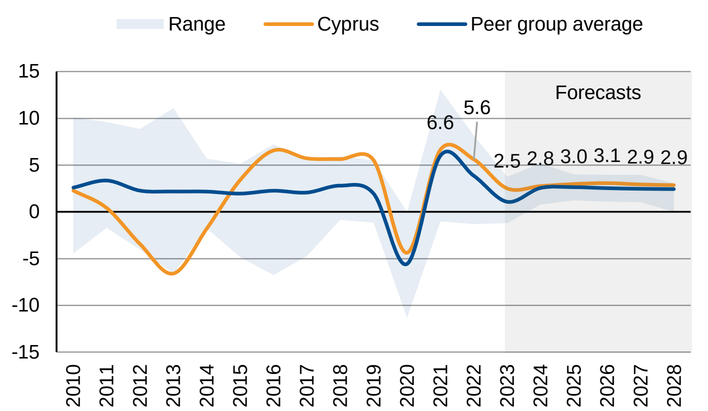
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Growth potential of the economy	Strong	+1/3	Strong growth potential supported by improving labour markets, foreign investment and reform
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; 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



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

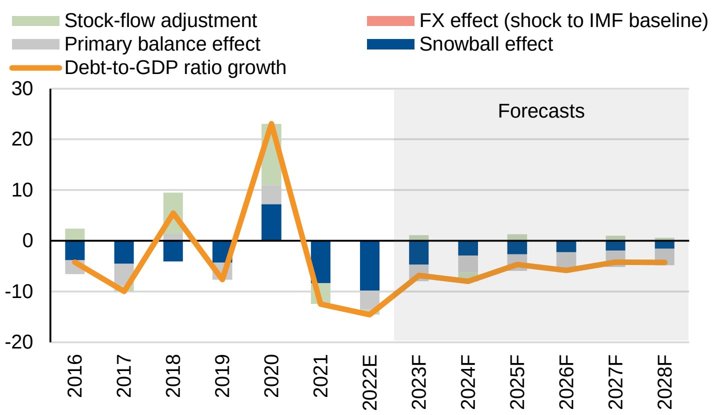
Public Finance Risks

- **Fiscal outlook:** Cyprus's fiscal position has improved markedly since the height of the Covid-19 pandemic. The budget balance improved rapidly to a surplus of 2.1% of GDP in 2022 from a deficit of 2% of GDP in 2021, reflecting better-than-expected revenue amid a strong economic rebound as well as withdrawal of pandemic support measures. Expenditures will rise moderately given the indexation of public wages and pensions to inflation while support to mitigate the cost-of-living crisis for households and businesses will be phased out by the end of June 2023. Conversely, inflation will also expand VAT tax revenue while strong economic performance will support income and wealth tax revenue growth (26.7% in Q1 2023). We expect the budget balance to narrow slightly to 1.9% of GDP in 2023 and then stabilise at 2% of GDP through 2028.
- **Debt trajectory:** Cyprus's debt trajectory is very favourable compared to euro area peers. Since peaking in 2020, public debt decreased by 27pps of GDP, reaching 86.5% of GDP in 2022. Solid fiscal performance, strong economic growth, and, to a lesser extent, the use of cash buffers to cover gross financing needs will support a rapid reduction in the debt-to-GDP ratio. Our baseline projects public debt to reach 80% of GDP in 2023 and to continue decreasing to 53% of GDP by 2028, one of the strongest debt reductions in the EU. Even under a stressed scenario that includes a substantial macro-fiscal shock and higher funding costs, debt is expected decline tangibly to 67.7% of GDP by 2028.
- **Debt profile and market access:** Cyprus benefits from a favourable debt profile supported by its pro-active debt management strategy. As of March 2023, Cypriot public debt had a low share of short-term debt (0.5%), no foreign currency exposures, limited interest rate risks (70% of debt is fixed rate) and a long weighted average maturity of 7.9 years for marketable debt. Rising inflation and ECB monetary policy tightening is pushing up financing rates with the 10-year government bond yield at around 4.125% in May 2023 versus 0.2% at the beginning of 2021 and the highest since 2016. In addition, a large cash buffer, comfortably covering short-term funding needs, provides additional funding flexibility.

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

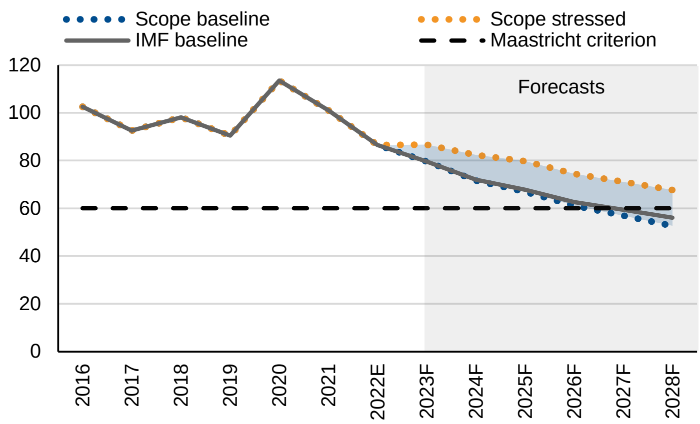
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Strong	+1/3	Good record of effective fiscal consolidation and overperforming fiscal targets, strong fiscal outlook
	Debt sustainability	Neutral	0	Elevated public debt; sharp increase in indebtedness due to Covid-19 crisis; very favourable debt trajectory
	Debt profile and market access	Neutral	0	Low interest payment burden, long average maturity, and limited interest rate risk

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

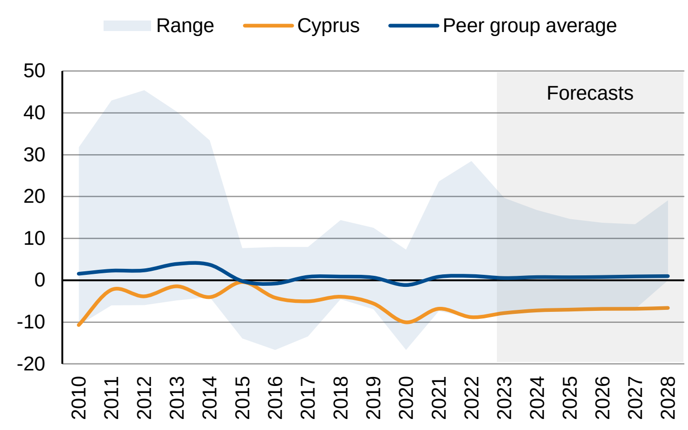
External Economic Risks

- **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 balance recorded a deterioration with the deficit of 9.1% of GDP in 2022, increasing from 6.8% in 2021. The current account deficit will narrow slightly but remain elevated level over the medium term given continued recovery in tourism but persistent import dependency and strong domestic demand. We expect the current account to average -7% of GDP over 2023-28, versus -3.8% over 2015-19.
- **External position:** Cyprus's external position is weak and remains a source of vulnerability. The net international investment position was very negative but has improved recently at -105% of GDP in 2022 (-41% of GDP after adjustment for the impact of special purpose entities), versus -118% of GDP (-45% of GDP) in Q4 2021. Low domestic savings led to the accumulation of high external debt, at 620% of GDP in 2022, though external debt has declined substantially in recent years, falling from the peak of 1,255% of GDP in Q4 2015. Most (46%) of external debt is made up of intercompany lending while a significant portion relates to special purpose entities with limited ties to the real economy.
- **Resilience to shocks:** As a small, open economy which is highly dependent on foreign funding and foreign demand, Cyprus remains exposed to short-term external shocks. Exports of goods and services represented 91.5% of GDP in 2022. This, combined with the external vulnerabilities highlighted above and large external gross financing needs present a risk to the Cypriot economy which remains exposed to liquidity and other risks as highlighted by the IMF. Euro area membership bolsters resilience to short-term shocks, however.

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

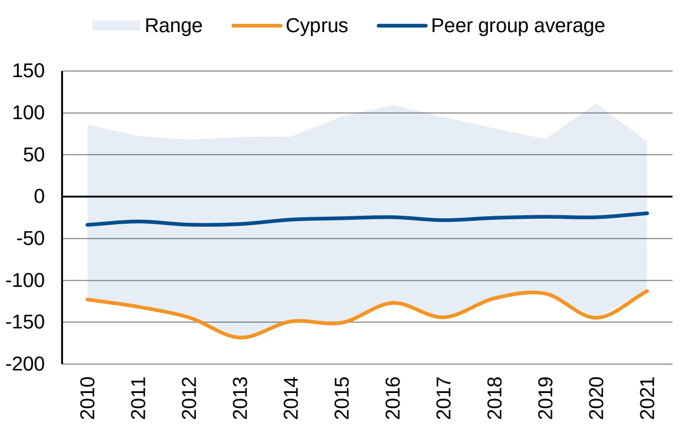
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
c	Current account resilience	Weak	-1/3	Consistent current account deficits with exports concentrated in a few key sectors
	External debt structure	Weak	-1/3	Large external debtor position and high external financing needs exacerbated by current account deficits
	Resilience to short-term external shocks	Weak	-1/3	Large external gross financing needs exposes the country to liquidity and other risks; euro area membership bolsters resilience to shocks

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

Financial Stability Risks

- **Banking sector:** Cyprus's banking sector resilience has continued to improve, but vulnerabilities remain. Capitalisation is sound and remains above pre-crisis levels, with an aggregate tier 1 ratio of 19.7% in December 2022, above the December 2019 level of 19.0%. The nonperforming loan (NPL) ratio stood at 9.3% in February 2023, down from 11% in December 2021. The banking sector continues to suffer from low though improving profitability thanks to higher interest rates and progress in lowering fixed costs. International financial market turmoil has had a muted impact on Cyprus so far due to a stable funding base and limited exposure. One key risk is the re-emergence of fragilities and an increase in NPLs given rising interest rates. Risks for the sovereign are mitigated by the country's favourable economic outlook and the banking sector's much smaller size compared to the previous banking crisis.

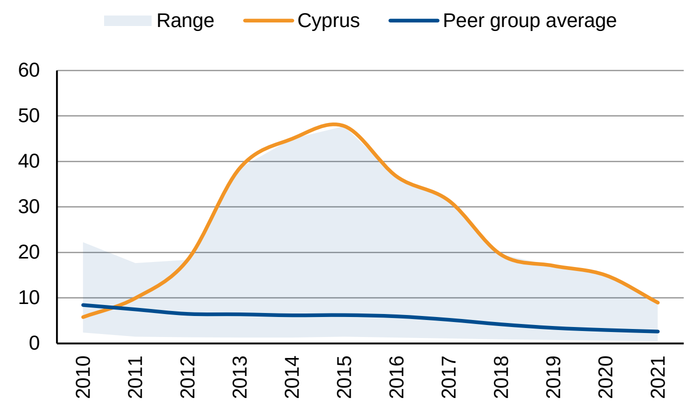
- **Private debt:** High private debt remains an important vulnerability although Cyprus has deleveraged substantially in recent years. Household debt, at 74% of GDP in 2022, is among the highest in the EU but is well below the 2013 peak of 130% of GDP. Similarly, consolidated nonfinancial corporate debt remains high at 145% of GDP in 2022, against the 2015 peak of 223% of GDP but well above the euro area average (78% of GDP). Excluding SPEs, private debt is lower and stood at 163% of GDP in 2022, while nonfinancial corporate debt stood at 89%. High inflation and rising interest rates amid high private indebtedness could lead to the crystallisation of financial risks, highlighting the importance of sound macroprudential policies.

- **Financial imbalances:** Risks related to the real estate sector appear limited for now given 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 (8% in December 2022 versus a 44% increase for the euro area). This reflects, in part, the difficulties experienced by the domestic banking sector which restrict the credit supply. The authorities have implemented several macroprudential measures to limit financial stability risks including loan-to-value and debt service to income limits as well as countercyclical capital buffers for other systemically important institutions.

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

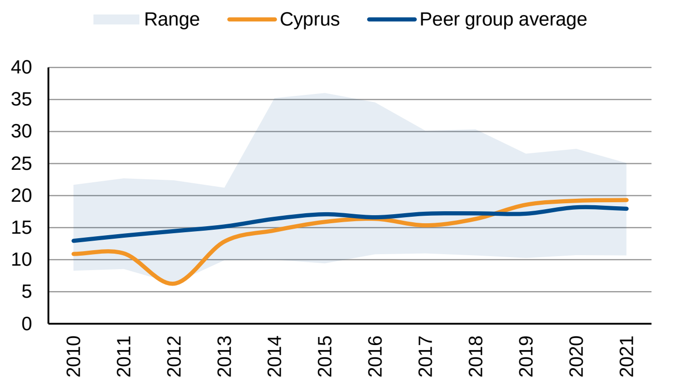
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Banking sector performance	Weak	-1/3	Poor asset quality and profitability pressures continue to weigh on banking sector performance but are improving
	Banking sector oversight	Neutral	0	Effective oversight; recently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

Non-performing loans, % of total loans



ource: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

ESG Risks

- **Environment:** Cyprus is particularly vulnerable to the adverse effects of climate change due to its position as a small Mediterranean island state. Cyprus is among the most carbon intensive economies in the EU (in emissions per unit of GDP). The country's National Energy and Climate plan – which is currently under review - sets an emission reduction target of 21% compared to 2005. Cyprus has launched an ambitious strategy to develop the electricity grid and expand its renewable energy capacity, which will critically support Cyprus's emissions reduction strategy. The country also launched a green taxation reform, including a carbon tax, a levy on water and a charge on household/landfill waste. Still, planned policies are insufficient to meet Cyprus' climate goals on a stand-alone basis, however, with the country relying on flexibilities under the Effort Sharing Regulation to meet its binding targets.

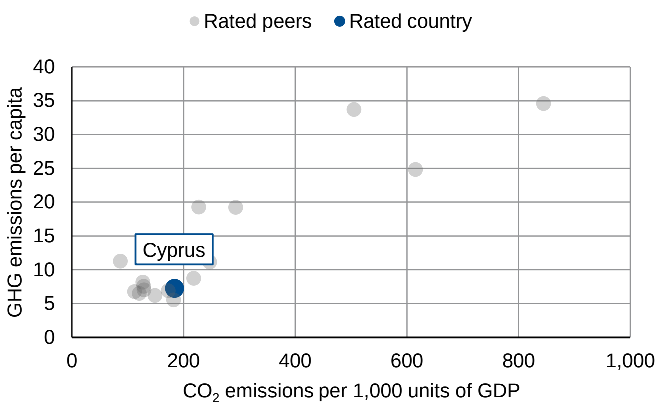
- **Social:** Cyprus benefits from favourable demographics and performs relatively well in terms of poverty, income inequality and health outcomes. Cyprus has posted one of the strongest improvements among EU countries regarding the share of people at risk of poverty or social exclusion from 22.8% in 2015 to 17.3% in 2021. 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 (5.5% of GDP versus a 4.8% EU average) while youth unemployment remains high, and substantial gender and age gaps persist.

- **Governance:** Cyprus underperforms the EU average on the World Bank's Worldwide Governance Indicators. The run-off presidential elections in February 2023 saw former foreign minister Nikos Christodoulides, running as an independent candidate, win with the backing of centrist and right-of centre parties. Important 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 but elections in Cyprus, Greece, and Turkey could renew impetus for negotiations.

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

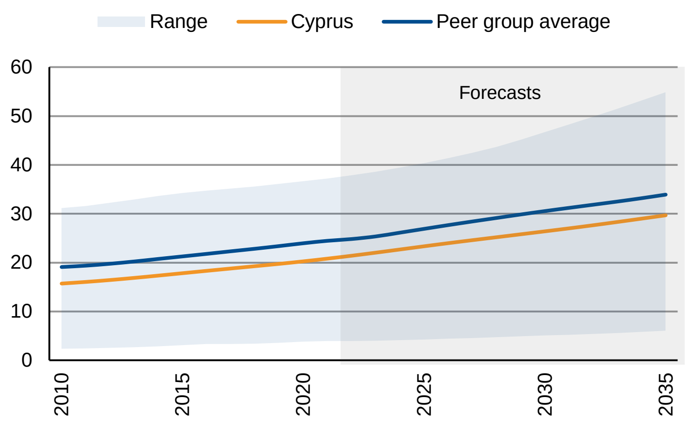
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental factors	Weak	-1/3	Elevated transition and resource risks; high mitigation costs due to geographical constraints and service-based economy
	Social factors	Neutral	0	Weak youth employment, gender equality and education outcomes; good performance on social protection, health, and income equality
	Governance factors	Weak	-1/3	Lingering geopolitical tensions and limited progress on reunification talks

Emissions per GDP and per capita, $mtCO_2e$



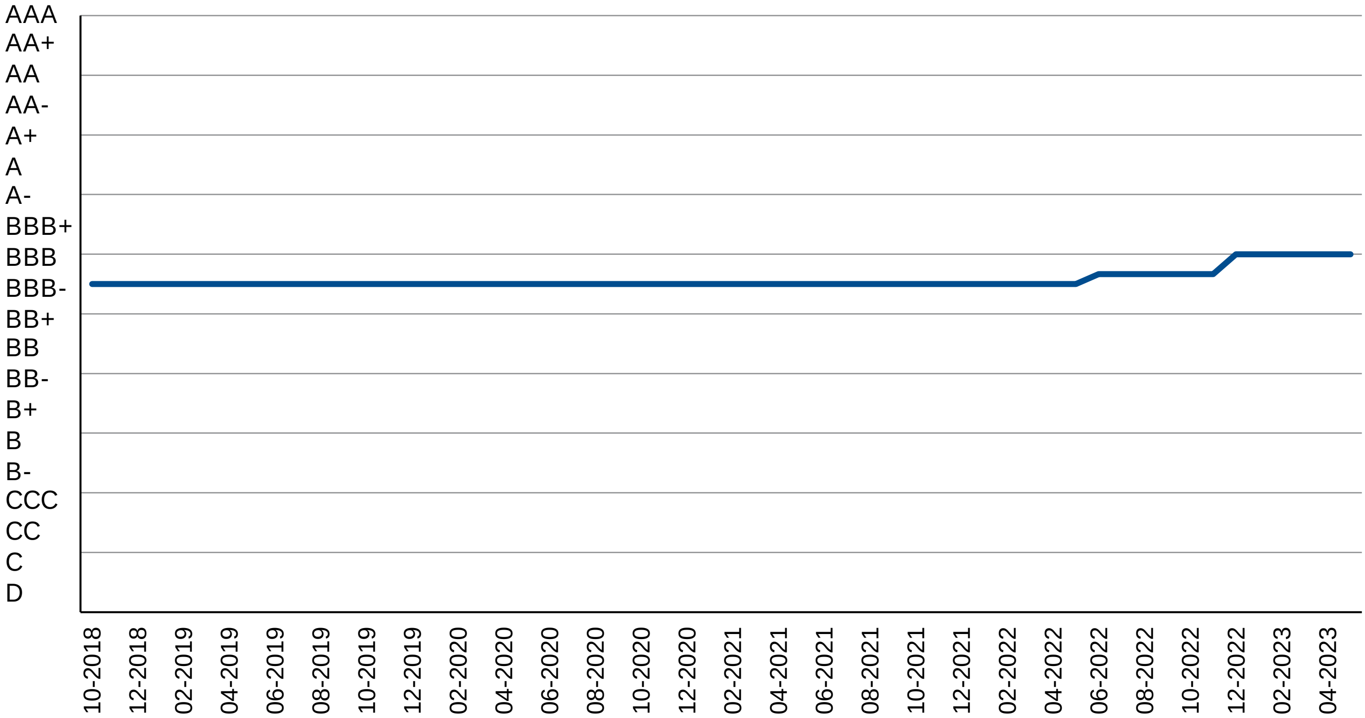
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

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, including a methodological reserve-currency adjustment.

Peer group*
Croatia
Estonia
Italy
Latvia
Lithuania
Poland
Portugal
Slovakia
Spain
United States

*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 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2018	2019	2020	2021	2022
Domestic Economic	**GDP per capita, USD '000s**	IMF	29.6	29.6	28.1	31.7	31.5
	Nominal GDP, USD bn	IMF	25.6	25.9	25.0	28.4	28.5
	Real growth, %	IMF	5.6	5.5	-4.4	6.6	5.6
	CPI inflation, %	IMF	0.8	0.6	-1.1	2.2	8.1
	Unemployment rate, %	WB	8.4	7.1	7.6	7.5	-
Public Finance	**Public debt, % of GDP**	IMF	98.1	90.4	113.5	101.1	86.5
	Interest payment, % of revenue	IMF	5.7	5.3	5.3	4.2	3.4
	Primary balance, % of GDP	IMF	-1.3	3.4	-3.8	0.0	3.7
External Economic	**Current account balance, % of GDP**	IMF	-4.0	-5.6	-10.1	-6.8	-8.8
	Total reserves, months of imports	WB	0.2	0.2	0.3	0.4	-
	NIIP, % of GDP	IMF	-121.4	-115.8	-144.7	-112.7	-106.6
Financial Stability	**NPL ratio, % of total loans**	IMF	19.5	17.1	15.0	9.0	-
	Tier 1 ratio, % of risk-weighted assets	IMF	14.6	17.1	18.3	19.0	18.9
	Credit to private sector, % of GDP	WB	136.2	107.7	108.8	-	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	208.4	198.2	184.9	183.8	-
	Income share of bottom 50%, %	WID	19.0	19.2	19.2	19.2	-
	Labour-force participation rate, %	WB	74.1	74.8	-	-	-
	Old-age dependency ratio, %	UN	19.3	19.8	20.3	20.8	21.4
	Composite governance indicators*	WB	0.8	0.8	0.7	0.7	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps)	58.2

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