Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF CYPRUS	Assigned Ratings/Outlook: **BBB- /stable**	Type: Monitoring, unsolicited with participation
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 11-03-2022 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating Action

Neuss, 11 March 2022

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "BBB-" for the Republic of Cyprus. Creditreform Rating has also affirmed Cyprus' unsolicited ratings for foreign and local currency senior unsecured long-term debt of "BBB-". The outlook is stable.

Key Rating Drivers

1. Relatively wealthy economy with a strong growth record; recovery more robust than initially expected and economy fairly resilient overall, aided by increasingly diversified services exports; near-term outlook clouded by intensifying cross-currents associated with still high exposure to tourism, as we expect current geopolitical developments to act as a drag on economic activity; negative spillover to global economic developments in particular from higher commodity prices could add to this
2. Medium-term growth prospects generally constructive, in particular with regard to envisaged measures and reforms partly-funded by the EU's Recovery and Resilience Facility (RRF); notwithstanding an overall moderate degree of economic diversification, economic resilience may thus be strengthened, including some boost to the business environment; a comparatively high level of private indebtedness points to limitations in terms of risk bearing capacities
3. Generally strong institutional framework, although latest set of Worldwide Governance Indicators (WGI) points to room for improvement; significant benefits from EU/EMU membership; we see progress in terms of judicial reforms and in stepping up combat against corruption and ML/FT, ongoing efforts should contribute to enhancing the institutional set up; we expect policy continuity following the general election in May 2021
4. Significant improvement of fiscal metrics reflecting ongoing economic recovery and the drawdown of the cash buffer following the Covid-19-related leap in the public debt ratio; we are generally confident that the sovereign will be able to bring its debt-to-GDP ratio onto a sustained downward path, but geopolitical events around the assault on Ukraine might cause some delay
5. Risks to fiscal sustainability persist, primarily relating to uncertainty over sufficient financing of the National Health System (NHS), elevated, albeit further declining NPE ratios in the banking sector, as well as risks from an elevated level of public guarantees; we continue to

think that these are balanced by sound debt management buttressed by a sound medium-term debt strategy, ample cash buffers, and debt affordability which is in turn supported by favorable capital market access and low funding costs; we expect this to persist for the time being

6. External risks, although somewhat distorted by the activity of special purpose entities' (SPEs), still constitute a source of vulnerability; previous improvements of the large negative net international investment position (NIIP) were halted by the pandemic, and might take longer to resume given currently intensifying headwinds to the pivotal tourism sector in particular; at this stage, any fast narrowing of the current account deficit appears unlikely

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

We assess Cyprus' macroeconomic profile as solid, boasting a phase of strong and above-euro-area-level economic growth prior to the pandemic and a comparatively swift economic recovery in the aftermath, also visible on the labor market. A relatively high wealth level in terms of GDP per capita adds to these positive aspects, whereas high private indebtedness could pose constraints to medium-term growth as this suggests limited risk buffers. If implemented effectively, NextGenerationEU (NGEU) funds will likely contribute to lifting comparatively low productivity, further enhancing economic resilience of an economy heavily concentrated on services. In the meantime, due to the dramatic events around Russian military aggression against Ukraine, downside risks related to possible further virus mutations are eclipsed by potentially wide-ranging economic consequences for the global economy from this recent escalation. Cyprus is likely to feel immediate adverse effects on its important tourism industry, apart from the higher burden placed on economic agents by higher energy prices.

Following five consecutive years of vivid economic growth well above the euro area (EA) level (average 2015-19: 5.4% vs. EA 2.0%), the Covid-19 pandemic caused total output to drop by 5.0% in 2020 (EA: -6.4%). Thanks to monetary policy support as well as rapid and comprehensive fiscal policy action both on the national and the international level, Cyprus' economy has been on a recovery course since Q3-20. Real GDP thus exceeded its pre-pandemic level (Q4-19) by 1.4% in Q4-21, regaining lost ground faster than the euro area as whole (EA Q4-21 vs. Q4-19: 0.0%), and earlier than expected during our last review back in Mar-21. In the final quarter of 2021, the q-o-q increase of total economic output moderated to 0.7%, likely held back by the spread of the Omicron variant, but ultimately proving fairly resilient and exceeding growth in the euro area (Q4-21: 0.3% q-o-q).

In 2021 overall, real GDP increased by 5.5% according to preliminary data, with consumption expenditure by households and the government contributing a combined 4.0 p.p., while gross fixed capital formation posed a drag (-1.2 p.p.). Thanks to a strong rebound in exports, net external trade added 2.8 p.p. to total output expansion last year. GDP per capita, estimated to have been at about USD 42,832 in 2021 (IMF, PPP terms), somewhat lags the EU level (2021: USD 48,305), but is largely in line with the median of our A-rated sovereigns.

[1] This rating update takes into account information until 04 March 2022.

In our view, Cyprus' heavy dependence on tourism and an overall moderate degree of economic diversification - the service sector accounted for 82.8% of total gross value added in Q3-21 (EA: 73.5%) - generally constitutes a potentially demanding economic set-up. Certainly the tourism sector is heavily affected by the global epidemiological crisis, and the events in Ukraine along with the international reaction to it will likely deal a severe blow to recently reinvigorated tourism activity (see below).

At the same time, a high and increasing GVA share of the ICT sector (Q3-21: 7.6%, EA: 5.2%), partly boosted by the fintech and the gaming industries, has contributed to economic resilience, acting as a supportive pillar in the face of the circumstances requiring social distancing. In addition, an increasing GVA share of business services (Q3-21: 10.9% of total GVA) has also enhanced diversification within the service sector.

With regard to Q1-22, we expect the pandemic-related constraints both locally and in other countries to leave their mark on Cyprus' economic output, although the effect is likely to be markedly smaller than in the initial stages of this pandemic, as economic agents are better adapted to the challenging circumstances by now. Moreover, a number of restrictions have been eased with effect from 21 February, but are generally supposed to remain in place until 14 March.

Given the high dependence on tourism, we will vigilantly monitor risks related to further virus variants and their potential impact on health and travel. We note that tourist arrivals had surprised in the course of 2021, having more than tripled compared to 2020 (206.7%). However, tourist inflows in 2021 still stood 51.3% below 2019 levels (Cystat). While export of travel and transport services remained affected by the pandemic over the first three quarters of 2021, continuing to fall short of the respective period in 2019, financial services acted as a stabilizing pillar, surpassing levels of 2019 over the corresponding quarters.

Prospects seemed about to brighten, given further progress in immunization against and treatment of Covid-19 internationally, and easing of restrictions in many countries. Moreover, the government announced 12 subsidy schemes in January 2022, aimed at further developing tourism services and thus attracting more visitors. However, we would flag that risks of a slower recovery in the tourism sector have materially increased, given that Russia as one of Cyprus' main trading partners in terms of services, accounting for 18.3% of total Cypriot service exports in 2019 (Eurostat), is now facing grave sanctions over its aggression against Ukraine.

Not only will the massively stepped-up Western sanctions weaken Russia's economic development, but higher commodity prices and possible adverse repercussions may hit Western countries and the global economy more generally to an extent. It has to be emphasized that Russia accounts for roughly a fifth of total tourism inflows (2019 Cystat data). In January 2022, tourists traveling from Russia even accounted for the largest group. Arrivals from the Ukraine accounted for 11.2% of all arrivals in that month, hinting at considerable revenue losses for the industry in the coming months.

Prior to the military assault on Ukraine, we would have viewed tourist inflows returning to 2019 levels by 2024 as feasible. Continuing progress of Covid-19 vaccinations would have facilitated a further gradual normalization of tourism, while a generally continuing global international business cycle would have added to that. Prospects for a full normalization of tourism now seem more remote. That said, the geopolitical situation is highly volatile, making external flows even harder to predict.

Private consumption should remain a growth contributor this year and next, given an overall resilient labor market development as mirrored by rapid recovery after bouts of increasing unemployment in the course of the global health crisis, considerably cushioned by wage subsidy and retention schemes. Compensatory schemes for jobs and incomes were in place until the end of October 2021, with a special focus on the tourism sector.

In the last few years prior to the corona crisis, the Cypriot unemployment rate had continuously declined, falling below the euro area level in 2019 and remaining there in 2020 (7.6% vs. 7.9% in the EA), despite some pandemic-related increase. In monthly terms, the unemployment rate was at 6.1% in January 2022 (Eurostat, LSF-adj.), down from 8.0% at the end of 2020, but following a temporary leap to 10.1% in May-21. Labor participation has remained higher than in the euro area, standing at 78.0% as of Q3-21 (EA: 74.1%). Drawing on quarterly employment data, total employment has continuously increased since Q4-20, slightly exceeding the level prior to the outbreak of Covid-19 in Q3-21 (EA: Q3-21 vs. Q4-19: -0.2%).

Wage increases may remain somewhat tamed by developments in the private sector for the time being, whereas public sector wages seem set to experience stronger increases, although partly as a consequence of previous cuts during the crisis. Hours worked will likely have to normalize further for stronger wage increases to occur on a broader base and not just in certain sectors experiencing acute shortages. There also remain some structural deficiencies on the labor market, as illustrated by the latest EU Social Scoreboard, e.g. when it comes to the share of young people not in employment, education or training (NEET), or per capita growth of gross disposable household income. Furthermore, we believe that consumer prices will pose a more pronounced drag on real disposable income going forward, mirroring the geopolitical situation and related price pressures pertaining to commodities and energy in particular. HICP inflation is set to increase further and descend more slowly.

With a view to the national Recovery and Resilience Plan (RRP), investment should remain well-supported going forward. The country is allocated approx. EUR 1.0bn in grants and 0.2bn in loans via the EU's RRF. In addition, we understand that private funding to the tune of roughly EUR 1.1bn is to be mobilized with regard to the RRP (Ministry of Finance, MoF). Apart from that, further funds to the tune of EUR 959mn (current prices) are allocated to Cyprus under the EU's Multiannual Financial Framework 2021-27.

We expect the abolition of the investor citizenship scheme from November 2020 to weigh somewhat on gross fixed capital formation, but risks in the near term appear relatively moderate, reflecting brisk domestic demand for residential property which benefited from the government scheme partly subsidizing interest on new mortgages more recently. Schemes to attract highly-qualified employees and 'digital nomads', and to incentivize some of these to acquire citizenship may continue to back (residential) construction after all, as should expansion and transformation of infrastructure in the tourism sector, as well as in energy and education.

At this stage, we expect Cyprus' real GDP to grow by about 3.1% this year, followed by some acceleration to 4.1% in 2023. The investment boost, associated with an effective implementation of RRP, represents a key assumption underlying the overall constructive medium-term growth outlook. The RRP is estimated to have an impact on GDP of about 1.5% this year and next (European Commission, EC). We are also aware of estimates by the University of Cyprus (May 2021) suggesting an accumulated increase of GDP by 6.8% over a 5 year-horizon.

Having said this, forecast uncertainty is extremely high at the current juncture, reflecting the geopolitical situation and still high uncertainty over the epidemiological developments. We would also stress high levels of private indebtedness as posing some downside risks to medium-term growth, especially if some tightening of monetary policy takes place, resulting in less benign financial conditions (see below). Estimates by the Central Bank of Cyprus (CBC) suggest that an interest rate increase by 100bp could result in a loss of up to 3.5% of households' net monthly income.

Cypriot households are among the most indebted in the euro area, with debt-to-disposable income amounting to 132.5% in Q4-20 (ECB, Q4-19: 129.5%). Regarding non-financial corporate debt, we observe that despite a continuous decline since a peak in 2016 the ratio stands at 162.4% of GDP in Q3-21 (Q3-20: 172.6%), corresponding to the second highest value in the euro area and pointing to limits to buffers against economic shocks. This said, debt readings are significantly inflated by SPE activities. Also, ECB data point to annual growth rates of outstanding loans to private households and NFCs having remained in negative territory over the last year, whereas new lending to households for house purchases as well as to NFC has trended up lately.

When it comes to Cyprus' business environment, latest available assessments by the EC, the World Economic Forum, and the World Bank hint at marked room for improvement, given a comparatively low ranking among the fellow euro area members. Tackling some challenges when it comes to public administration, as well as enhancing the efficiency of the justice system and stepping up the fight against corruption, as is foreseen in the RRP, should prospectively contribute to improvements in this respect. As a case in point, we note that the law aiming to simplify procedures for strategic investments has been enacted. Further to this matter, the MoF presented a new strategic plan in Oct-21 with the aim of attracting foreign investment, including the intended creation of a Business Facilitation Unit.

Looking at the degree of digitalization of the economy and among society, rank 21 among the 27 EU members with regard to the DESI 2021 also points to some catching-up potential. Still, Cyprus has managed noticeable progress compared to the preceding year, when it was ranked 24th, and we would also assess as positive the 2020 establishment of the Deputy Ministry of Research, Innovation and Digital Policy (DMRID), which is responsible for implementing the 'Digital Strategy for Cyprus (2020-2030)', aiming to bundle forces and accelerate Cyprus' digital transformation.

Turning to recent developments as far as indicators capturing cost competitiveness are concerned, we would highlight that the global export market share was stable over the period 2018-2020, masking an increase in the global share of services exports from 0.25% to 0.31% over this period. While in a longer-term comparison (2020 vs. 2011), real ULC appears favorable, conditions seem to have deteriorated somewhat when one focuses on the last few years as seen from 2020 (20 vs. 17 and 20 vs. 19). A less advantageous stance seems to be attributable to a stronger fall in real labor productivity per person than in real compensation per employee, although these developments obviously tend to be distorted by the pandemic and measures taken to shield the labor market from greater harm. Generally, we believe that risks concerning misaligned productivity and wage growth are modest, since productivity is set to increase, whereas wage pressure in the private sector seems limited at this stage. Moreover, data relating to the first half of 2021 suggest that real unit labor costs may have moderated last year.

Picking up on productivity issues, we note that productivity growth could be fostered by ramped-up ICT capital, which may well start to take off with the implementation of the RRP. In the same vein, stepped-up R&D expenditure, which at an average of 0.7% GDP (EA: 2.2% of GDP, GERD, Eurostat) is among the lowest in the EU, could prove beneficial as well. Together with envisaged reforms of the public administration and the judiciary, as mentioned above, we would expect some boost to productivity growth, helping to make potential growth more sustainable or even enhance it further. Already among the highest in EU-27, potential growth is expected to be at around 2.7% this year and accelerate to 3.0% in 2023 (EA: 1.6% in 2022 and 1.7% in 2023).

Institutional Structure

Cyprus' creditworthiness remains underpinned by a generally strong institutional set-up. Benefits associated with EU/EMU membership, as also highlighted by the comprehensive EU aid package in response to the pandemic, as well as by the ECB's accommodative stance and emergency measures in the corona crisis, continue to represent an important factor in our assessment. Demonstrated responsiveness to recommendations by high-level institutions and related sound policy-making over recent years strengthen our confidence in a timely and effective implementation of reforms envisaged in the RRP, which should also contribute to further enhancing of the institutional framework. We continue to monitor ongoing tensions between Cyprus and Turkey over oil and gas drilling activity.

The parliamentary election in May 2021 yielded the conservative DISY as the strongest party (17 seats) and AKEL (15 seats) as the main opposition party. DIKO obtained 9 of the 56 seats to be filled in this election. While securing the backing of opposition parties for a broad-based government proved difficult for incumbent President Anastasiades, and notwithstanding a reshuffling of government shortly after the election amid resignation of the justice minister and the health minister, we do not expect any significant policy changes. The next presidential election is scheduled for February 2023.

Judging by the latest set of the WGIs, our preferred measure when it comes to assessing institutional quality and governance, we observe that Cyprus' relative ranking has deteriorated across the four pillars on which we put particular emphasis. Generally, the sovereign continues to trail the euro area median in this respect. Apart from a more marginal drop from 45th to 48th position out of 209 economies (EA median: 35) in the latest vintage as regards the perceived quality of policy formulation and implementation, the relative deterioration concerning voice and accountability, rule of law and control of corruption seems more pronounced. In terms of voice and accountability, the sovereign ranks 52nd (EA median of 33), 62nd as far as rule of law is concerned (EA median of 32) and 72nd with regard to control of corruption (EA median of 43).

That said, we are aware of further steps taken to enhance efficiency of the justice system, a long-standing weakness, notwithstanding some remaining challenges which were also echoed by the latest EU-Rule of law report (July 2021), as well as a more recent opinion by the Venice Commission (Dec 2021) on three bills for reforming the judiciary. To be sure, the justice system is still burdened by a high backlog of cases and a comparatively long period of time to arrive at final decisions, in part owing to lack of supporting staff and the need to step up the use of digital tools. Nevertheless, authorities forge ahead to adopt new rules of civil procedure with the aim of reducing proceedings time. Moreover, the 'ijustice system' was fully implemented as of February 2022, according to DMRID, which is likely to help speed up procedures.

With regard to measures taken to improve on control of corruption, we would highlight that, following several years of delay, parliament passed the law this February enabling the establishment of an independent anti-corruption authority to tackle corruption in the public sector. In addition, parliament enacted legislation aiming to increase transparency over political lobbying.

Likewise, as far as the combat of money laundering and financing of terrorism is concerned, we take note of some improvements made by Cyprus when it comes to compliance with the Financial Action Task Force's (FATF) standards in this regard. The latest follow-up report issued by Moneyval in January 2022 considers that Cyprus complies with 16 and largely complies with 20 out of 40 FATF recommendations.

Concerning other reforms likely to play a role with regard to an effective implementation of the RRP, we follow developments over an envisaged reform of public resource management, with the first phase to take effect in 2023. The recent local government reform bills passed by parliament (03-Mar-22) have come a long way, consolidating 30 municipalities into 20 to enhance financial and administrative autonomy as well as the related transparency and accountability, with a transition period until May 2024.

Following termination of the citizenship for investment scheme in November 2020, against which the EC had launched an infringement procedure which is still ongoing, the State's audit service continues its probe to uncover any potentially unlawful cases of granting citizenship, with a preliminary report expected in the near future. In a number of cases, the government reportedly intends to rescind granted citizenship, reinforcing our impression of the sovereign's responsiveness to EU issues.

Given the aim to achieve carbon neutrality by 2050, the largest part of the funds from the RRF (41%) is to be dedicated to the environmental transition, which may be deemed as essential given significant Cypriot challenges pertaining to green growth. Indeed, ample room to improve with regard to greening its economy was attested by the EC in its assessment of the national RRP, as well as by the EC's Eco-Innovation Index, according to which the sovereign ranks 22nd among the EU members. Cyprus' greenhouse gas emissions per capita stood at 11.2 tons in 2019 (up from 10.1 tons in 2013), corresponding to one the highest readings in the EU. At 16.9% (2020, preliminary data), its overall share of energy from renewable sources has more than doubled since 2013 (8.4%), while moving in the lower range among EU countries (EU-27 2020: 22.1%), mainly due to a comparatively low share of renewable sources in gross electricity consumption. The national Energy and Climate Plan (January 2020) mentions the aim of reaching an overall share of energy from renewable sources of 23% by 2030.

Fiscal Sustainability

In the wake of an ongoing economic recovery and partly aided by the large cash buffer, fiscal metrics have been fast improving, following a large headline deficit and a spike in the public debt ratio in 2020. Overall, this firms our confidence in the government's ability to bring the high public debt ratio onto a sustained downward path in the aftermath of the health crisis, acknowledging risks related to further virus mutations and adverse reverberations stemming from the Ukraine conflict. Fiscal risks entailed by a high level of public guarantees and an elevated stock of non-performing exposures (NPE) in the relatively large banking sector persist, despite noticeable further declines on both counts and our impression of a broadly resilient banking sector. The further roll-out of the NHS could still place a higher burden on fiscal outcomes. Continued sizeable cash buffers and a benign debt profile as a *result of sound debt management continue to balance fiscal risks to some extent. The same applies to the very accommodative monetary policy stance which, against the backdrop of the current circumstances, may remain in place for a longer period after all.*

The general government budget was on average close to a balanced position over the period 2015-19 (-0.2% of GDP, EA: -1.1% of GDP). Driven by the corona crisis, the headline balance shifted from a surplus of 1.3% of GDP in 2019 to a pronounced deficit of -5.6% of GDP in 2020, although the outturn was less negative than registered in the euro area overall or other prime tourism destinations in Europe.

As the corona crisis continued last year, parliament approved four supplementary budgets, the most recent in October 2021 over an amount of EUR 91.7mn, entailing the extension of a number of aid measures for the health sector as well as support to businesses. Moreover, implementation of the second phase of the reform of the NHS lifted social payments, while also leading to increased contributions on the revenue side.

Nevertheless, based on preliminary figures, the rapid and sustained economic recovery since Q3-2020 and the expiry of some of the discretionary Covid-19 measures helped to shrink the deficit to 1.8% of GDP last year (Cystat), markedly below the level estimated in our last review. Thus, the sovereign's primary balance already turned positive in 2021. Total revenue registered a strong recovery (16.0%, ESA2010), well above the authorities' estimates in the DBP22, driven by increases in tax revenue and social security contributions. Total expenditure grew by 5.8%. Apart from strong increases in social security payments, public sector wages rose by 3.6%.

With a view to the current year, the government's overall fiscal stance is likely to be slightly expansionary. The budgetary impact from the abovementioned extension of some support schemes could be around 0.2% of GDP in 2022. What is more, negative economic effects due to higher energy and other commodity prices, and sanctions/countersanctions in connection with the Russian war in Ukraine, might call for renewed government support going forward. As a case in point, the Cypriot parliament on 03-Mar-22 passed measures estimated to have a fiscal impact of about EUR 40mn to reduce energy costs for households.

Apart from that, we are aware of the government's plans to implement a fiscally neutral tax reform to strengthen the economy's competitiveness and Cyprus' position as an international finance and business hub, to be completed in 2022. The reform is envisaged to include, inter alia, raising the corporate tax rate from 12.5% to the internationally agreed minimum rate of 15%, the introduction of a carbon tax, and the reduction or abolition of the special levy on the deemed and /or actual distribution of dividends.

Notwithstanding substantial uncertainty, we would currently expect the headline deficit to narrow slightly in 2022, to about 1.5% of GDP and further to about 0.8% of GDP in 2023. As to the medium-term, the government envisages the headline balance to return to a surplus in 2024. Risks seem heavily tilted to the downside at this stage, given that the abovementioned adverse effects from war in Eastern Europe may at least slow down the recovery, despite the likely positive effects of a timely implementation of the RRP. The latter may experience some delay as well in view of the current dramatic geopolitical events. Remaining uncertainty over new variants of coronavirus add to fiscal downside risks. Developments with regard to a further roll-out of the NHS may also turn out come at a higher cost than currently envisaged.

Consolidated general government debt amounted to roughly EUR 24.3bn at the end of 2021 (MoF), corresponding to a significant decline in the debt ratio from 115.0% of GDP in 2020 to approx. 103.9% of GDP, based on preliminary GDP figures, and partly driven by the use of sizeable cash reserves accumulated over recent years. Going forward, we expect the public debt ratio to remain on a downward path, echoing government expectations for debt-to-GDP to fall below 100% this year - although risks have increased that the recovery may at least slow down or be interrupted by the current geopolitical events, with possible negative implications as to the speed and amount of reducing debt-to-GDP. Acknowledging substantial uncertainty over any forecasts at this stage, we would tentatively expect the general government debt-to-GDP ratio to decline to about 97.9% this year (2023e: 92.4%), and to continue to diminish over the medium term.

We continue to see fiscal risks emanating from an elevated level of contingent liabilities despite their retreat, with public guarantees posting at 14.6% of GDP in 2021, including guarantees linked to the financial sector (6.5% of GDP, DBP22). For this year, MoF forecasts a further decline. Contingent liability risks also continue to exist with regard to the banking sector, which however has weathered the pandemic fairly well. This said, given the sector's relatively high exposure to the tourism sector, current events linked to Russia may well have adverse consequences. We observe that the CET1 ratio, which in Q3-21 stood at 16.3% (Q3-20: 16.6%, EBA), continues to point to a relatively comfortable capitalization level (EU Q3-21: 15.7%). Profitability as measured by return on assets has recovered somewhat after 2020, but remains low (Q3-21: 0.1%, EU: 0.5%).

Following the expiry of a second loan moratorium in place until Jun-21, adverse effects on asset quality seem to have been limited, judging by a further decline of the NPE ratio, falling from 11.2% in Q3-20 to 5.7% in last year's third quarter (EBA data). That said, asset quality compares very unfavorably from a European perspective (EU Q3-21: 1.9%). Drawing on more comprehensive NPE data provided by CBC, the respective ratio (including third country branches) was at 17% as of Q2-21. In order to assess potential additions in this respect, we continue to follow closely EBA data on loans and advances with non-expired moratoria. A third of these were classified as stage 2 loans in Q2-21 (33.4%), up from 21.8% in Q2-20, but down from 38.6% in Q1-21.

Whilst take-up of the government-backed ESTIA scheme, aimed at facilitating NPE restructuring, appears to have been low, a new scheme in force since Sep-21 (OIKIA) is particularly aimed at vulnerable borrowers. Related to these issues, efforts to strengthen Cyprus' insolvency framework are ongoing. Apart from that, we will also pay attention to further developments around the intended transformation of KEDIPES into an asset management company, as this may involve more pressure on public finances.

In any case, we consider sound debt management and affordable debt mirroring favorable market access and low funding costs, as well as EU financing, in particular via RRF, as key factors mitigating known as well as imminent fiscal risks. Apart from pre-financing via the RRF (Sep-21: EUR 157mn), which allocates 5.1% of 2021 GDP to Cyprus overall, Cyprus also received loans of EUR 603mn under the EU's labor market instrument SURE. Interest payments shrank by a further 5.9% in 2021 (2020: -10.2%, Cystat), pushing the interest-to-revenue ratio down to 4.4% (2020: 5.4%), which still compares as somewhat elevated among euro area members.

At its monetary policy meeting this February, the ECB confirmed its intention to discontinue the PEPP in March, and the implementation of a smoothing mechanism entailing a temporarily higher rate of net asset purchases under the Asset Purchase Program following the expiry of the PEPP. As of January 2022, cumulative net purchases of Cypriot government bonds under the

PEPP had amounted to about EUR 2.5bn, adding to roughly EUR 4.2bn in net purchases of government bonds under the PSPP, totaling 28.9% of 2021 GDP.

Following February's Governing Council meeting, an interest rate hike by the ECB already in 2022 rather than in 2023 had appeared more likely, although ultimately dependent on the Governing Council's assessments as to duration, depth, and breadth of price pressures. At this stage, we would still assume a first rate hike to occur towards the end of 2022. In any case, we expect the ECB to signal readiness not only to maintain its accommodative stance for now, but to contribute to bridging any potential disruptions and cushion the likely adverse effects from renewed energy price increases and sanctions on the euro area economy, in light of the dramatic developments amid the Russian invasion into Ukraine.

We gather that government financing needs for 2021 were covered by issuance of 5-y international bond in February 2021, as well as by reducing the relatively high cash position which at the end of 2021 had stood at roughly 12% of GDP (MoF). Even after the reduction, cash reserves would cover gross financing needs in excess of 12 months ahead, according to MoF, which we consider a further credit positive element as it provides a sizeable buffer, significantly reducing short-term refinancing risks. Indeed, the MoF aims to maintain cash buffers of this size over the medium term. Smooth access to financial markets and good use of advantageous conditions was demonstrated in January of this year when the Cypriot authorities successfully placed a 10-year international bond in the amount of EUR 1bn.

To be sure, the main financing instrument in the current year will continue to be international bonds. As another factor adding to contained fiscal risks, we would reiterate a benign maturity profile, recalling that ESM loan repayments are not due until 2025. Overall, loans from the official sector accounted for about 33% as of Sep-21 (MoF). The weighted average maturity of debt as of Sep-21 stood at 7.8 years (2016: 7.5 years, MoF).

Foreign Exposure

As a small open economy operating a current account deficit and a large negative NIIP, although exaggerated by SPE activity, Cyprus displays external vulnerabilities. While subsiding pandemic risks would open up space for some reversal of the pandemic-induced widening of Cyprus' negative current account position, the latest escalation in the Russia-Ukraine conflict and associated sanctions will likely have adverse consequences which at this stage are very difficult to quantify. The improvement of Cyprus' negative NIIP observed before the outbreak was halted by the pandemic and may deteriorate at least in the short term as a result of current geopolitical events.

Having averaged 3.9% of GDP in the years 2015-19, Cyprus's current account deficit widened markedly in light of the Covid-19 crisis. Cyprus registered the largest negative position as a percentage of GDP (-10.1% of GDP) among the euro area members in 2020, driven by a considerably smaller surplus in services trade (-3.6 p.p. to 16.7% of GDP) coming on the back of collapsing tourism. A larger deficit in the primary income balance also contributed to the growing current account deficit in the first year of the pandemic.

More recently, the current account deficit stood at 10.4% of GDP in Q3-21, measured as a four-quarter-rolling-sum. A recovery of the service balance was more than made up for by an increasing goods deficit in light of stronger import activity and by a widening primary income deficit.

While risks related to the coronavirus seem to be receding somewhat at this stage, thus improving perspectives for tourism, we flag downside risks to external trade and the external position from the escalation of the Russian-Ukraine conflict and associated severe sanctions against Russia. A substantial shrinking of the current account deficit towards pre-pandemic levels may take longer under the current circumstances, but is subject to high uncertainty at this stage.

Likewise, bearing in mind that by individual country Cyprus recorded the largest assets and liabilities stocks vis-a-vis Russia in Q3-21, the NIIP may deteriorate further under the current circumstances, although any assessment of the effect of the sanctions seems premature. CBC data relating to 2020 highlights that roughly a quarter (24.9%) of inward FDI stocks stemmed from the Russian Federation. Similarly, roughly a third of outward FDI went to Russia. Any underlying changes following the termination of the investor citizenship scheme in Nov-20 may be masked by changes from these latest geopolitical developments.

The Covid-19 crisis halted the improvement of Cyprus' NIIP observed before the pandemic. Cyprus still displays one of the most negative positions in the EU, recently deteriorating to -131.4% of GDP in Q3-21 (Q3-20: -125.4% of GDP). Excluding non-defaultable instruments (NENDI), the position deteriorated further to -170.4% of GDP in 2020 (2019: -167.0%), at face value further underscoring risks from external exposure. However, we have to reiterate that such risks appear less pronounced when the NIIP adjusted for the negative position related to SPEs - essentially active in the shipping industry - is taken into account. Excluding the position associated with SPEs, the NIIP had dropped to a nevertheless high -48% of GDP as of Q2-21, down from -50.3% of GDP at the end of 2020.

Rating Outlook and Sensitivity

Our rating outlook for the Republic of Cyprus is stable. Downside risks have increased sharply regarding the macroeconomic backdrop, fiscal outlook and foreign exposure, in particular in light of the current geopolitical context. However, we view the swift economic recovery experienced so far, significant EU-level funds supporting the intended transformation towards more sustainable economic growth, some progress regarding reforms likely to enhance the institutional framework, and the above-mentioned factors mitigating fiscal risks, as offsetting downside risks at this stage. We have to emphasize that the assessment and interpretation of economic developments remains considerably more challenging than under normal circumstances, as is the case for other indicators, in particular from the fiscal realm.

We could lower the sovereign's credit ratings or outlook, if developments in Ukraine lead to a clear and pronounced deterioration of economic prospects on the global and national level, and if there are signs that previous improvements of fiscal metrics may be halted or even reversed over a longer period of time. Risks related to asset quality in the banking sector and other contingent liabilities might be higher on the agenda again in such a scenario. New coronavirus variants reigniting concern over sufficient immunization might be part of a risk scenario as well.

Conversely, we could consider a positive rating action if the medium-term growth outlook remains constructive despite current risks to the global economy and tourism to Cyprus, on the back of effective implementation of the RRP and resilience through a higher degree of diversification of services. A further decline of NPEs and a continued downward trend of the debt ratio could also prompt us to raise Cyprus' ratings or the outlook.

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Ratings*

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

*) Unsolicited

ESG Factors

ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demographics
Labor	Equality	Technology & Infrastructure	Saftey & Security	**Judicial system**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	**Business Environment**	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In what follows, we explain how and to which degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign, e.g. the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator, add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating's considerations on macroeconomic performance of the sovereign, and we regard the ESG factor 'Labor' as significant to the credit rating or adjustments thereof.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2016	2017	2018	2019	2020	2021e	2022e
Macroeconomic Performance							
Real GDP growth	6.5	5.9	5.7	5.3	-5.0	5.5	3.1
GDP per capita (PPP, USD)	35,852	38,277	40,795	42,233	40,007	42,832	44,953
Credit to the private sector/GDP	235.2	209.5	142.7	114.6	116.6	100.1	n/a
Unemployment rate	13.0	11.1	8.4	7.1	7.6	n/a	n/a
Real unit labor costs (index 2015=100)	98.0	98.0	98.2	99.9	102.8	n/a	n/a
Ease of doing business (score)	72.3	72.3	72.8	73.4	n/a	n/a	n/a
Life expectancy at birth (years)	82.7	82.2	82.9	82.3	82.3	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	0.7	0.9	0.8	0.8	0.6	n/a	n/a
WGI Control of Corruption (score)	0.8	0.8	0.6	0.6	0.4	n/a	n/a
WGI Voice and Accountability (score)	1.0	1.1	1.0	1.0	0.9	n/a	n/a
WGI Government Effectiveness (score)	1.0	0.9	0.9	1.0	0.9	n/a	n/a
HICP inflation rate, y-o-y change	-1.2	0.7	0.8	0.5	-1.1	2.3	2.7
GHG emissions (tons of CO2 equivalent p.c.)	11.4	11.6	11.3	11.2	n/a	n/a	n/a
Default history (years since default)	3	4	5	6	7	8	9
Fiscal Sustainability							
Fiscal balance/GDP	0.3	1.9	-3.5	1.3	-5.6	-1.8	-1.5
General government gross debt/GDP	103.1	92.9	98.4	91.1	115.0	103.9	97.9
Interest/revenue	7.0	6.4	6.0	5.6	5.4	n/a	n/a
Debt/revenue	273.3	241.6	250.9	229.6	292.7	n/a	n/a
Total residual maturity of debt securities (years)	4.9	4.8	5.0	5.9	7.9	7.8	n/a
Foreign exposure							
Current account balance/GDP	-4.2	-5.1	-4.0	-5.7	-10.1	n/a	n/a
International reserves/imports	0.1	0.1	0.1	0.1	0.1	n/a	n/a
NIIP/GDP	-133.8	-136.1	-125.6	-116.1	-136.7	n/a	n/a
External debt/GDP	1,144.4	1,024.7	894.3	843.3	880.9	n/a	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Cystat, 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
Monitoring	24.04.2020	BBB- /stable
Monitoring	12.03.2021	BBB- /stable
Monitoring	11.03.2022	BBB- /stable

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. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Ministry of Finance (MoF) participated in the credit rating process as it provided additional information 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 MoF during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). 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 our website.

To prepare this credit rating, CRAG has 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, European Investment Bank, Blavatnik School of Government, ECDC, 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 with 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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