Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF CYPRUS	Assigned Ratings/Outlook: **BBB+ /positive**	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 09-02-2024 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating Action

Neuss, 09 February 2024

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

The rating upgrade on the Republic of Cyprus reflects

(i) marked outperformance of fiscal expectations on the back of strong nominal growth, with pronounced general government surpluses contributing to a rapid reduction of the debt-to-GDP ratio;

(ii) further progress in reducing vulnerabilities in the banking sector, including further reduction of non-performing loans (NPLs)

(iii) a stronger than expected economic growth performance, boosted by recovering tourism, underscoring underlying resilience in a challenging international environment

The outlook revision on the Republic of Cyprus reflects

(i) expectations for solid medium-term growth on the back of regained strength in the tourism sector, robust labor market developments, and progressing implementation of structural reforms in the context of NGEU;

(ii) favorable prospects with regard to a further significant decline in the public debt ratio over the medium term, buttressed by the economic growth outlook, expected fiscal surpluses and ample cash reserves; and

(iii) expectations for ongoing progress in dealing with vulnerabilities in the banking sector

Key Rating Drivers

1. Resilience of the economy coupled with a solid growth record has led to a considerable rise in GDP per capita levels; we expect real GDP growth to slow down this year in light of dampened foreign demand, but to be holding up well by European comparison, with private consumption being supported by the positive labor market situation, and investment benefiting from EU funding

2. Constructive medium-term growth perspectives against the backdrop of the implementation of reforms and investments under the Recovery and Resilience Plan (RRP), maintaining positive expectations for productivity and potential growth; the relatively high level of private indebtedness and an overall moderate degree of economic diversification pose some limitations to risk-absorbing capacities, although improvements have continued
3. Generally strong institutional set-up with scope to improve on several governance aspects by European comparison, as reflected by the latest set of Worldwide Governance Indicators; important steps towards enhancing the quality and efficiency of the justice system more recently, as well as towards strengthening the prevention of corruption
4. Public finances improved significantly in 2022 and 2023, thanks to robust economic activity, the gradual abolition of support measures, and the recourse to ample cash reserves; we deem a further reduction in the debt-to-GDP ratio over the medium term to be likely, expecting consecutive headline surpluses, sound nominal GDP growth and another drawdown of cash reserves, although the development of fiscal metrics remains subject to increased uncertainty due to geopolitical tensions
5. External risks continue to represent a source of vulnerability, although the highly negative net international investment position (NIIP) remains distorted by special purpose entities (SPEs); pronounced current account deficits seem set to persist over the medium term

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

Cyprus' solid macroeconomic profile is underpinned by its resilience against the recent succession of shocks, displaying high growth rates in the aftermath of the pandemic and in the phase of surging energy prices in connection with Russia's invasion of Ukraine. As a result, the level of GDP per capita continued to rise significantly. Adding to favorable developments, tourism has recovered strongly, almost matching pre-pandemic levels. Labor market developments have remained favorable, and advancements in the implementation of projects under NGEU, potentially strengthening productivity and underlying growth, add to positive medium-term prospects. Relatively high levels of private indebtedness and energy import dependency, as well as structural challenges linked to the business environment, balance these strengths to some extent.

Having already recorded a strengthening in economic activity in 2021, Cyprus' economy saw robust growth in 2022, posting at 5.1%. The economic recovery rested on a strong performance of domestic demand, in particular on private consumption and, to a lesser extent, gross fixed capital formation, as well as on a build-up in inventories. At the same time, net exports subtracted materially from real GDP growth.

Considering the five-year period from 2018-2022, Cyprus' average growth rate exceeded the corresponding euro area reading by far, standing at 4.6% (EA: 1.3%), providing a boost to its relatively high per-capita income. Drawing on IMF data (PPP terms, current prices), Cyprus' GDP

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[1] This rating update takes into account information available until 02 February 2024.

per capita increased by 11.9% between 2021 and 2022, corresponding to nearly 95.0% of the weighted EU average income level.

With a view to last year, the growth trajectory remained overall positive, but is likely to have moderated somewhat. Quarterly growth rates displayed pronounced volatility. Total output rose by 1.0% in Q1-23, declining again by 0.4% in Q2-23. In Q3-23, real GDP expanded by 1.1% q-o-q, with exports of services and private consumption representing main growth drivers. Household spending held up relatively well, thanks to pronounced growth in wages and employment. Sentiment indicators and available hard data point to a slowdown of economic activity in Q4-23, but still remaining relatively resilient.

Having acted as a vital stabilizing factor during the energy price shock caused by Russia's war against Ukraine, tourism remains an important driving force. Total tourist arrivals in 2023 were almost back to the level registered in the pre-pandemic year 2019, increasing by another 20.1% against 2022, thus reaching 96.7% of the 2019 numbers. In this context, it is worth noting that the breakaway of the Russian tourist market seems to have been well absorbed, with tourist arrivals from the UK, Poland, Germany, Austria and others largely making up for this.

Travel services exports reflected the recovery in tourism as well, standing 22.8% higher in the first three quarters of 2023 compared to the same period of the previous year (BoP data, nominal terms). Generally, the economy remains heavily service-oriented, with services accounting for 84.4% of gross value added (GVA) as of Q3-23 (EA: 72.6%), although we assess the fact that there has been an increasing degree of diversification within the service sector over recent years as positive.

In light of retreating inflationary pressure, and related prospects for monetary policy rate cuts in the course of this year and next, foreign demand should gradually improve. That said, risks of disruptions amid ongoing geopolitical tensions remain pronounced, with recent developments in the Red Sea, a vital transport route, adding to this. Overall, we expect the contribution of net external trade to real GDP growth to be broadly balanced this year before turning slightly positive next year.

Meanwhile, private consumption should be buttressed by strong wage growth on the back of the wage indexation mechanism, as well as by fading inflationary pressure and favorable labor market developments. The implementation of the new cost-of-living adjustment (COLA), which increased basic salaries by 66.7% instead of 50.0% of the annual increase of the CPI in 2022, as well as the increased monthly minimum wage from 1 January 2024 (+6.8% to 1000 euros), act as further support to household spending. Headline inflation fell to 1.9% in December 2023 (EA: 2.9%), compared to an average of 3.9% in 2023, while the core rate - which also decreased - remained on a higher level. Given the abovementioned tensions on the global stage, risks for renewed price spikes - in particular for energy prices - cannot be disregarded.

Labor market developments remain constructive, notwithstanding moderating employment growth. The latter still posted at 1.3% y-o-y in Q3-23, having grown vividly in 2022 (3.0%, EA: 2.3%). Cyprus' unemployment rate fell below the euro area level in Jan-23, declining since then and standing at 6.1% in Dec-23 (Eurostat data). We believe that growing sectors such as tourism and ICT will continue to contribute to favorable labor market conditions.

As regards structural factors, we note that labor participation continues to compare favorably to the euro area as a whole, with the gap towards the euro area widening in favor of Cyprus over recent years. According to latest available data (Q3-23), Cyprus' labor participation stood at

79.3% (EA: 75.1%), hinting at successful labor market integration policies. Having said that, a somewhat mixed performance concerning the European Commission (EC) social scoreboard suggests there is also some way to go when it comes to aspects of 'equal opportunities', e.g. the share of young people neither in employment nor in education.

Prospects for gross fixed capital investment remain backed by investments related to the RRP. While private investment remains affected by restrictive financing conditions as a consequence of the still tight monetary policy stance, there is a pipeline of major private sector projects that are foreign funded and there should be some positive knock-on effects from RRF-financed investment. Moreover, relief regarding financing conditions emerges on the horizon, as we expect rate cuts by the ECB and other central banks as the year progresses.

Between January and October 2023, building permits decreased by 6.9% y-o-y, suggesting lacking impulses via the construction sector lately. On the other hand, construction confidence showed an improving tendency over the last three months. Apart from that, we believe that the government's interest rate subsidy scheme for new business and housing loans will likely cushion the adverse impact of currently high bank lending rates to some extent.

We expect real GDP to have cooled to 2.4% in 2023 on the whole. Assuming that domestic demand remains the key supportive pillar to economic growth in 2024 and 2025, we project growth to increase to 2.6% in 2024 and 3.0% in 2025. Evidently, the forecasts are subject to lingering uncertainty over geopolitical developments.

The medium-term growth outlook remains backed by reforms and initiatives to foster the twin transformation (green and digital), including measures that could prove conducive to enhancing productivity and, ultimately, potential growth. At the end of last year, the European Commission and the Council of the EU approved Cyprus' modified RRP, complementing the original plan with a REPowerEU chapter. The amended plan, which focuses more strongly on the green transition, is now worth EUR 1.22bn, with EUR 1.02bn to come via grants and EUR 0.2bn via loans.

In Dec-23, Cyprus submitted its second payment request (EUR 152mn) from the Recovery and Resilience Facility (RRF), covering 33 milestones and 5 targets in, among other areas, public health, public administration, education, digitalization, energy efficiency and renewable energy. In the meantime, the EC has disbursed EUR 20.9mn in connection with a RePowerEU pre-financing to Cyprus (Jan-24). The next payment request from the RRF is worth EUR 89mn and expected to be submitted in Mar-24. In the context of available EU funds, the Ministry of Finance (MoF) announced the full absorption of cohesion policy funds pertaining to the 2014-2020 cycle, encompassing EUR 880mn, making Cyprus one of the first EU countries to achieve this milestone and maintaining a positive outlook for the take-up of respective funds over the new period (2021-2027).

According to EC estimates, potential growth will come to 3.5% in 2024 and 3.2% in 2025, which would be well above the corresponding values for the euro area (2024: 1.4%, 2025: 1.3%) and its ten-year average over 2013-2022 (2.3%, EA: 1.1%, AMECO data). Adding to a favorable backdrop to achieve this, Cyprus has again been classified as a strong innovator in the latest version of the European Innovation Scoreboard (Jul-23), which, among other things, emphasizes trademark applications and innovative SMEs collaborating with others as relative strengths, while R&D intensity displays catching-up potential.

Given the competition for talent, it also seems worth highlighting that the share of ICT specialists in employment has caught up with the EU level in 2022, accounting for 4.6% in 2022 (EC intelligence). Also on the global level, Cyprus performs relatively well in terms of innovation, occupying rank 28 (out of 132 countries) in the UN's Global Innovation Index, with particularly strong performance in the pillars 'knowledge and technology outputs' and 'creative outputs'.

By contrast, hinting at scope for improvement, we note that Cyprus slipped by five ranks in the IMD World Competitiveness Ranking 2023 to rank 45 (out of 64 economies), hinting at scope for improvement. In part, businesses face the difficulty of finding suitable financing sources. According to the 2022 SME Access to Finance Index (European Investment Fund), Cyprus scored second lowest among the EU countries, illustrating comparatively limited access to finance for SMEs, which also seem to be burdened with relatively high electricity prices due to structural factors such as lack of competition and comparatively limited use of renewable energy.

Turning to competitiveness factors from a cost-focused angle, Cyprus maintains a relatively favorable position compared to its main European trading partners and the euro area as a whole, judging by recent real unit labor cost developments. Its worldwide share of goods and services exports was stable in 2022, masking a decrease in the global share of export services in that year, which nevertheless still exceeded its pre-pandemic reading.

We see some downside risks to the medium-term growth outlook from the comparatively high level of private debt, as this puts some constraints on buffers against economic shocks. However, the respective ratios have followed a firm downward path over recent years. Measured against disposable income, household debt fell from 120.7% in 2021 to 112.6% in 2022. Partly thanks to high nominal GDP growth, non-financial corporate (NFC) debt declined by 10 p.p. y-o-y to 137.8% as of GDP in Q3-23 (Central Bank of Cyprus, CBC) representing the EU's second highest value, although this reading is biased by the activities of special purpose entities (SPEs). Moreover, it has to be stressed that more recent trends point to contracting volumes of private sector lending, especially outstanding loans to NFCs.

Focusing on energy topics, Cyprus' relatively high dependency on oil imports renders the economy vulnerable to shocks on the commodity market. Oil and petroleum products accounted for 85.1% of its energy mix in 2022. That said, efforts to step up the use of renewables are under way. At the same time, we understand that Cyprus recently reached a deal with a U.S. energy company concerning the exploitation of a gas field, potentially also raising an option to export gas further out.

Institutional Structure

We view the sovereign's institutional framework as generally strong, benefiting from EU/EMU membership, e.g. in the form of access to significant financial support via NGEU and the EU cohesion policy funds. Somewhat balancing these strengths, Cyprus exhibits room to improve compared to euro area standards in terms of quality of governance, as illustrated by the latest update of the World Bank's Worldwide Governance Indicators (WGIs). While challenges remain, important steps have been undertaken to strengthen the quality and efficiency of its justice system, as well as to enhance combat against corruption, generally adding to the impression of a high degree of responsiveness to recommendations by relevant institutions concerning reforms and policy measures in the past. Likewise, our perception is that there is ongoing commitment to a timely and effective implementation of reforms *under the RRP. With regard to recent tensions over gas drilling in the Mediterranean Sea, we will continue to monitor developments in relations between Cyprus and Turkiye.*

Drawing on the latest edition of the WGIs, referring to the base year 2022, we observe a somewhat mixed picture with regard to Cyprus' rank among the four pillars to which we pay particular attention in our assessment of institutional quality. While there are slight improvements in terms of 'control of corruption' (rank 73 out of 213, EA median rank: 49) and 'government effectiveness' (rank 53, EA median rank: 43), by 5 and 3 places, respectively, its rank of 55 with regard to 'voice and accountability' was almost stable, whereas in terms of 'rule of law' its slipped by 5 places to 67th (EA median rank: 36).

We note that the EC's Rule of law report (Jul-23) highlights substantial reform progress concerning the structure of the court system, among others the splitting of the current Supreme Court into two distinct courts, the Supreme Constitutional Court and the Supreme Court and establishment of a new Court of Appeal. These changes, as well as the project for the elimination of the backlog of cases pending before the courts, required also the appointment of a large number of judges, To be sure, there remain some challenges regarding the justice system, as illustrated by the finding that the rate of resolving civil, commercial, administrative, and other cases in 2021 was the lowest among all EU countries for which data were available (EU Justice Scoreboard 2023). Apart from that, the level of digitalization appears low, with limited digital solutions to initiate and follow proceedings in corresponding cases in 2022. However, reform projects to address this are ongoing, with the e-justice system currently expected to be operational in 2024 and digital audio recording of court proceedings in Q1-25.

Adding to positive aspects concerning the institutional set-up, further advancements have been made in the field of prevention of corruption, with the independent anti-corruption authority having become operational (Dec-22) and the implementation of the national anti-corruption strategy proceeding as planned. In an addendum to the second compliance report on prevention of corruption with respect to members of parliament, judges and prosecutors (Jan-24), GRECO states that Cyprus has implemented nine out of sixteen recommendations satisfactorily or in a satisfactory manner, while the remaining seven recommendations have been partially implemented. In an evaluation report of the fifth evaluation round (Oct-23), scope for improvement in terms of the asset disclosure of high-ranking government officials and structural mechanisms of the police as Cyprus' main law enforcement body were among the issues mentioned.

With respect to the political environment, we expect policy continuity and continued progress on key structural reforms and fiscal targets. In the February 2023 presidential election, the independent candidate and former minister of foreign affairs, Nikos Christodoulides, won the election in the second round, obtaining 51.97% of the votes. The recent government reshuffling in the context of which the president replaced the health, justice, defense and agriculture ministers ultimately does not alter our expectation of the continuity of major policy priorities.

Turning to greening the economy, there seems marked room to improve, whilst the trend remains positive. At 19.4% in 2022, the share of energy from renewable sources remained below the EU average (23.0%, Eurostat), but continued to climb. Only 17.0% of Cyprus' gross electricity consumption was generated from renewable sources in 2022, compared to 41.2% in the EU overall. Cyprus continues to exhibit one of the EU's highest per capita greenhouse gas (GHG) emissions levels, standing at 10.3 tons per head in 2021. With a view to eco-innovation capabilities, Cyprus moved among the EU's lower third in 2022 in the respective index compiled by the EC, likewise indicating potential for catching-up.

In a bid to meet the objectives outlined in the 'Fit-for-55' package, Cyprus has submitted a revised draft of the National Energy and Climate Plan (NECP) over 2021-2030 to the EC. The updated version comprises investment to the tune of EUR 17.7bn, including additional public investment of EUR 540mn, some of which is provided from REPowerEU funds. A final NECP is set to be submitted to the EC by June 2024.

Fiscal Sustainability

Strong nominal growth in combination with a gradual phasing out of pandemic support measures has led to a significant improvement in the budget balance, which in addition to drawing on sizeable cash reserves, induced a substantial further reduction in the general government debt-to-GDP ratio. We expect the latter to remain on a rather steep downward trajectory on the back of continued surpluses, high nominal GDP growth, and a further partial reduction in cash reserves. Downside risks to this expectation arise from persistent geopolitical tensions and related disruptions potentially weighing down on public finances, while contingent liability risks emanating from NPLs and stage 2 loans have further receded. We regard sound debt management and a favorable debt structure as factors mitigating fiscal risks, contributing to maintaining favorable debt affordability, despite less benign capital market conditions.

At 2.4% of GDP in 2022, Cyprus' fiscal surplus came in stronger than we had estimated in our last review (Feb-23: 1.5% of GDP), constituting the highest in the EU (EU: -3.3% of GDP, EA: -3.6% of GDP). The better outturn was supported by the winding down of COVID-19 related measures and buoyant economic growth, which was reflected in a marked increase in tax receipts and net social contributions.

Drawing on preliminary general government balance data from Jan-Nov-23, the highly positive fiscal developments continued last year, putting Cyprus on course for a more pronounced surplus than in 2022, driven by a broad-based rise in tax revenues, which in turn benefited from high inflation and nominal GDP growth as well as sustained employment growth. Total general government expenditure was boosted by the increase in public wages, partly related to the automatic wage indexation mechanism. In addition, social transfers were on the rise due to pension expenditure.

According to the Draft Budgetary Plan 2024 (DBP24), the negative budgetary impact of discretionary measures in 2023 and 2024 was estimated to amount to about 0.6% of GDP and 0.3% of GDP, respectively. However, taking into account recent decisions for the extension/re-introduction of a number of measures in response to inflationary pressure, the negative impact from the discretionary measures is estimated to come to about 1% of GDP and 0.4% of GDP in 2023 and 2024, respectively. In addition, the government also approved a mortgage-to-rent scheme in 2023, with the intention to protect the homes of vulnerable households, which will be implemented by the state-owned asset management company KEDIPES in 2024. The government expects the scheme to exert an adverse fiscal impact of around 0.6% of GDP (EC intelligence).

Based on the abovementioned preliminary data, we expect Cyprus to have concluded 2023 with a headline surplus of 3.3% of GDP. With the expected robust growth, and barring severe further escalation regarding the war in Ukraine and/or major headwinds from flaring tensions in the Middle East, we expect Cyprus to continue to record general government surpluses in 2024 and

2025. At this stage, we would pencil in a positive headline balance to the tune of 2.0% of GDP in 2024 and 2.2% of GDP in 2025.

After already falling significantly in 2021, Cyprus' debt-to-GDP ratio dropped sharply again by 13.7 p.p. to 85.6% of GDP in 2022, thus falling below its pre-pandemic level (2019: 93.0% of GDP) and the average public debt ratio of the euro area as a whole (EA 2022: 90.9% of GDP). The reduction in the debt-to-GDP ratio was mainly due to a drawdown of the cash buffer, with the strong nominal growth also contributing. Given the above fiscal developments, the public debt ratio remained on a rapidly descending trajectory in 2023 on the back of a primary surplus, a continued marked expansion of nominal GDP, and a further decline in cash reserves. According to recent data (Q3-23, Eurostat, preliminary data), Cyprus' debt-to-GDP ratio stood at 79.4% of GDP, and it should have decreased to roughly 76.9% of GDP at the end of 2023. We expect the debt-to-GDP ratio to decrease to 69.0% of GDP in 2024 and 61.9% of GDP in 2025, thus approaching the Maastricht threshold of 60% of GDP next year.

Even though they have retreated to comparatively moderate levels and appear manageable in our view, we will continue to monitor contingent liabilities risks. Public guarantees are estimated to have decreased to 2.9% of GDP in 2023 (MoF). Cyprus' banking sector gives a rather resilient impression, also boasting a strong deposit base and a high degree of capitalization. The CET1 ratio came to 19.2%, exceeding the EU average by a wide margin. In the meantime, the Central Bank of Cyprus (CBC) has activated macroprudential levers, lifting the countercyclical capital buffer from 0% to 0.5% with effect from 30 November 2023, and further to 1.0% as from 2 June 2024. The higher level of geopolitical tension accentuates risks related to cyber attacks, representing a vulnerability of the sizeable banking sector and posing a risk to the stability of the overall financial system.

While the NPL ratio has further decreased to a more moderate level (Q3-23: 2.6%, Q3-22: 3.2%, EBA data), it remains among the highest in the EU (Q3-23: 1.8%). An above-EU-average share of stage 2 loans (Q3-23: 11.3% vs. EU 9.2%) entails some vulnerabilities, potentially leading to a more pronounced deterioration of the asset quality in the banking sector, given high interest rates and an associated lower debt-servicing capability of highly leveraged households and corporates. That said, stage 2 loans are also on the decline.

However, the resolution of NPLs which had previously been adversely affected by the suspension of foreclosures, resumed in February 2023. Important steps have been made towards increasing the effectiveness of the foreclosure framework, with several bills passed on this issue in December 2023. Included in the legislative package is a law that enables the fast-tracking of cases, subject to conditions. The mortgage-to-rent-scheme executed by KEDIPES is to assist in addressing NPLs as well, with success depending on the uptake of the scheme. We will closely monitor the impact of the legislative package and the scheme on the reduction of NPLs, as well as any new events around the disposal of loan portfolios held by KEDIPES.

Debt issuance costs have increased as a result of the interest rate tightening cycle. The yield on 10-year government bonds drifted upwards in 2022 and came down somewhat during the last months of 2023, amid financial market expectations over a turning monetary policy cycle in 2024. As of 26-Jan-2024, the corresponding yield stood at 3.3%, while the Bund spread decreased as well, coming to 101.4 bp. We recall that the Republic of Cyprus issued its first sustainable bond at an amount of EUR 1bn in April 2023, adding to increased variety in the ways in which capital markets are tapped into.

With regard to the current monetary policy environment, the ECB Governing Council decided to keep key policy rates unchanged at the meeting in Jan-24 and stressed the intention to maintain the current interest rate level for as long as necessary. We think that a first rate cut around the middle of 2024 is becoming a likely scenario, also given some inflation volatility currently. The winding down of the APP portfolio is proceeding as planned and the ECB reaffirmed its intention to discontinue reinvestments under the PEPP at the end of 2024.

Fiscal sustainability risks are partly mitigated by a variety of factors, including the sovereign's sound debt management and benign maturity profile. As of Dec-23, Cyprus' average weighted maturity amounted to a relatively long 8.0 years, up from 7.7 years one year before (ECB data), and short-term debt of the general government accounted for a low 0.1% at the end of 2023 (MoF). Approximately 27% of Cyprus' total public debt was held by the ESM as of Dec-23, which at the same time covered the lion's share of Cyprus' floating-rate debt. The repayment of the outstanding debt to the ESM (EUR 6.3bn), which is planned to begin with an initial amount of EUR 0.35bn in 2025 before averaging EUR 0.99bn per year until 2031, will thus imply a decrease in Cyprus' floating-rate debt. As ESM loans carry a relatively low interest rate and due to low gross financing needs, the weighted average cost of debt increased only slightly.

Judging by the interest-to-revenue ratio, debt affordability has further improved. The reduction in the share of interest in total general government revenue to 3.2% in Q3-23 was due to both a numerator and a denominator effect, with interest expenditure falling and revenue rising. The sovereign continues to maintain sizeable cash reserves to draw on, acting as another mitigating factor to fiscal risks. According to the PDMO, the cash buffer could cover gross financing needs of the next nine months more than seven times as at the end of Dec-23. We also assess the fact that Cyprus does not feature any foreign-currency denominated debt as positive.

Foreign Exposure

Against the backdrop of the sovereign's status as a small open economy and featuring a large negative NIIP, external vulnerabilities remain relevant. That said, several factors serve as risk-mitigants, including the observation that the net external debtor position remains distorted by activities of special purpose entities (SPEs), and its composition includes a pronounced share of foreign direct investment. Notwithstanding a strong recovery in tourism since the pandemic, Cyprus' current account balance deteriorated further, and we do not expect the deficit to return below pre-pandemic levels in the near term.

The current account deficit widened to 7.9% of GDP in 2022, standing well below the long-term average over 2012-2021 (-4.5% of GDP). Given Cyprus' sensitivity to fluctuations in global oil prices, which is related to its high energy import dependency, the oil import bill became significantly more costly, together with other higher prices for commodities resulting in a deteriorating trade balance. The primary income balance continued to move in negative territory as well, with repatriations of profits of foreign companies a dominant factor.

Measured as the four-quarter average, Cyprus' current account balance worsened to -9.5% of GDP in Q3-23, due to higher domestic demand, an increasing registration of ships, and a widening primary income deficit. Reflecting more positive positions in the travel and ICT categories, the slight improvement in the services balance was not sufficient to compensate for the negative impact in the components mentioned above. We expect the current account balance to improve only moderately in the near term, as export growth of services (except for tourism) should decelerate somewhat following strong post-pandemic readings. Easing pressure from energy and commodity components on headline inflation should enable a narrowing of the current account deficit over the medium term.

Despite recording an improvement in its NIIP by 7.8 p.p.to -96.2% of GDP in 2022, and standing at a similar level as of Q3-23 (-96.9% of GDP), Cyprus continues to represent one of the EU's largest net external debtors. Factoring out the impact of SPEs, the NIIP stood at -34.7% of GDP in the first nine months of 2023 (Cystat data), suggesting lower external risks than implied by raw data. We also note that external risks are mitigated by the composition of the NIIP at face value, with a large net liability position in foreign direct investment partly reflecting attractiveness for foreign investments.

Rating Outlook and Sensitivity

Our rating outlook on the Republic of Cyprus is positive, as we expect fiscal and macroeconomic risks to moderate over the next 12-24 months.

A positive rating action could be prompted by a further substantial decline in the public debt ratio, with tangible further progress in reducing vulnerabilities in the banking sector. Solid growth of the economic activity, facilitated by marked progress in implementing RRP projects and favorable labor market developments would likely be conducive as well.

Although the positive outlook indicates that a downgrade is rather unlikely, we could contemplate a negative rating action if economic growth comes to a halt or displays recessionary tendencies, possibly as a consequence of an aggravation of geopolitical tensions. Significant delays of the RRP execution could add negatively. A negative rating action could also be triggered by a sharp reversal of the downward moving public debt ratio. Materializing contingent liability risks associated with the banking sector could be a factor causing or contributing to such a scenario.

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Ratings*

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

*) Unsolicited

ESG Factors

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 the following, we explain how and to what 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 to 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.

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

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 assessment of a economy's competitive stance by e.g. the World Bank, the World Economic Forum, the European Commission, and IMD Business School and the World Intellectual Property Organization (UN) add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

While Covid-19 may exert 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 on public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2018	2019	2020	2021	2022	2023e	2024e
Macroeconomic Performance							
Real GDP growth	5.6	5.5	-3,4	9.9	5.1	2.4	2.6
GDP per capita (PPP, USD)	41,349	43,829	41,884	46,249	51,774	53,931	56,600
Credit to the private sector/GDP	142.26	113.78	114.16	93.74	77.93	n/a	n/a
Unemployment rate	8.4	7.1	7.6	7.5	6.8	n/a	n/a
Real unit labor costs (index 2015=100)	98.2	99.5	102.7	98.0	91.5	90.4	90.1
World Competitiveness Ranking (rank)	41	41	30	33	40	45	n/a
Life expectancy at birth (years)	82.9	82.3	82.4	81.3	81.7	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	0.7	0.7	0.5	0.6	0.6	n/a	n/a
WGI Control of Corruption (score)	0.6	0.6	0.3	0.4	0.4	n/a	n/a
WGI Voice and Accountability (score)	1.0	1.0	0.9	0.9	0.8	n/a	n/a
WGI Government Effectiveness (score)	0.9	1.0	0.8	0.7	0.7	n/a	n/a
HICP inflation rate, y-o-y change	0.8	0.5	-1.1	2.3	8.1	3.9	2.5
GHG emissions (tons of CO2 equivalent p.c.)	11.4	11.3	10.0	10.3	n/a	n/a	n/a
Default history (years since default)	5	6	7	8	9	10	11
Fiscal Sustainability							
Fiscal balance/GDP	-3.6	0.9	-5.7	-1.9	2.4	3.3	2.0
General government gross debt/GDP	98.5	93.0	114.9	99.3	85.6	76.9	69.0
Interest/revenue	6.0	5.6	5.4	4.4	3.6	n/a	n/a
Debt/revenue	252.6	236.1	298.2	247.9	207.5	n/a	n/a
Total residual maturity of debt securities (years)	4.3	6.8	7.9	7.7	7.9	8.0	n/a
Foreign exposure							
Current account balance/GDP	-4.0	-5.6	-10.0	-6.1	-7.9	n/a	n/a
International reserves/imports	8.6	11.3	14.1	15.6	14.7	n/a	n/a
NIIP/GDP	-125.2	-115.4	-133.4	-104	-96.2	n/a	n/a
External debt/GDP	891.7	824.2	794.8	692.1	609.6	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
Monitoring	10.02.2023	BBB /stable
Monitoring	09.02.2024	BBB+ /positive

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. 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) and the Central Bank of Cyprus (CBC) participated in the credit rating process as they provided additional information and data, and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of MoF and CBC 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	YES
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, World Intellectual Property Organization (WIPO), IMD Business School, Central Bank of Cyprus, Republic of Cyprus – Ministry of Finance, Public Debt Management Office, Statistical Service of Cyprus (Cystat), Fiscal Council of Cyprus.

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.

No ancillary services in the regulatory sense were carried out for this rating object. Creditreform Rating AG ensures that the provision of ancillary services does not present conflicts of interest with its credit rating activities and discloses ancillary services provided for the rated entity or any related third party, if any, in its rating reports. For the complete list of provided rating and credit service ancillaries please refer to https://www.creditreform-rating.de/en/about-us/regulatory-requirements.html#non-core-busi-ness-activities.

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.

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