19 October 2018

Public Finance

# Republic of Cyprus Rating Report

**BBB-** STABLE OUTLOOK

## Credit strengths

- Euro area membership
- Economic recovery
- Fiscal consolidation
- Moderate refinancing needs

## Credit weaknesses

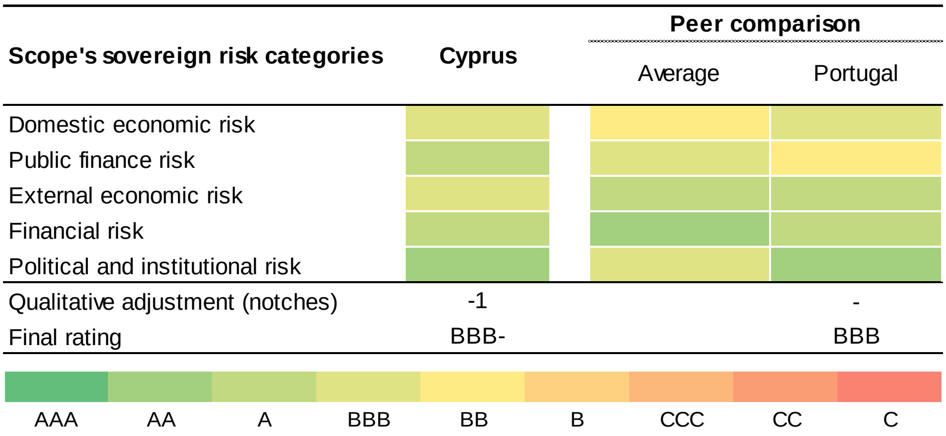
- High NPLs and weak banking sector
- High public debt
- High private and external debt
- Fragile market access

**Rating rationale and Outlook:**

The BBB- rating is supported by Cyprus’ euro area membership and subsequent access to a conditional lender of last resort (the European Stability Mechanism), the ongoing economic recovery and restructuring of the banking sector, fiscal outperformance, and moderate refinancing needs. However, the still-too-high stock of non-performing loans remains a key credit weakness given i) its impact on the fragile banking sector, constraining profitability and credit lending; and ii) the risk it poses to government finances in the context of a high public debt burden and still-fragile market access.

As a small economy serving as a regional financial hub and business centre, Cyprus has elevated external liabilities, partly driven by the activities of Special Purpose Entities (SPEs), and is also vulnerable to international initiatives on corporate taxation and/or the retrenchment of cross-border financial intermediation by foreign banks. The Stable Outlook reflects our assessment that the risks Cyprus is facing are broadly balanced.

**Figure 1: Sovereign scorecard results**



| Scope's sovereign risk categories | Cyprus | Peer comparison | |
|---|---|---|---|
| | | Average | Portugal |
| Domestic economic risk | 🟩 | 🟨 | 🟩 |
| Public finance risk | 🟩 | 🟩 | 🟨 |
| External economic risk | 🟩 | 🟩 | 🟩 |
| Financial risk | 🟩 | 🟩 | 🟩 |
| Political and institutional risk | 🟩 | 🟩 | 🟩 |
| Qualitative adjustment (notches) | -1 | | - |
| Final rating | BBB- | | BBB |

Source: Scope Ratings GmbH

Note: The comparison is based on Scope’s Core Variable Scorecard (CVS), which is determined by the relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with one selected country chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

## Positive rating-change drivers

- Strengthened banking sector
- Sustained reduction in public, private and external debt
- Reduction of geopolitical risks

## Negative rating-change drivers

- Reversal of fiscal consolidation
- Reversal of structural reforms
- Banking sector risks crystallise as additional government liabilities

## Ratings and Outlook

**Foreign currency**

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

**Local currency**

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

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## Domestic economic risk

**Resilient performance given prudent economic and fiscal policies and progress on structural reforms**

Following the exit from its EU-IMF economic adjustment programme in March 2016, Cyprus' economy has grown robustly, averaging 4.4% since Q2 2016, driven by solid private consumption, mostly foreign-funded investment (which is almost up to the pre-crisis level at around 21% of GDP, in line with the euro area level), tourism and related construction, business services, and retail trade. These positive developments are underpinned by the country's prudent economic and fiscal policies and progress on structural reforms, leading to gains in price competitiveness over recent years, with real unit labour costs at 10% below their 2010 levels, in line with that of Portugal and below relative developments in the euro area. Cyprus' economic recovery has also benefited from the ECB's accommodative monetary policy and the stabilisation of the country's banking system.

Going forward, we expect real GDP growth to average around 3.8% during 2018-20, driven by foreign-funded investment (raising the risk of a new boom-and-bust cycle in construction) and robust domestic demand given a continuously improving labour market, relatively low inflation and weak payment discipline, boosting real household disposable incomes. Specifically, employment has risen every year since 2014, with the increase this year expected to exceed 400,000, up about 37,000 since the trough in 2014, while unemployment has fallen to 7.3% in Q2 2018 from 17.6% in Q1 2015. While headline inflation is up at around 1.7% as of September 2018, core inflation (excluding energy and unprocessed foods) remains subdued at around -0.2%. In addition, as noted by the IMF, higher payment discipline to service debt would likely curtail household consumption, curbing domestic demand.

**Moderate potential growth outlook**

Thus, once the foreign-funded investments are completed, Cyprus' economic growth is expected to moderate to between 2% and 2.5%. While this growth potential remains above that of Portugal (1.2%) and the euro area average (1.7%), it also reflects Cyprus' already moderately high level of per capita income, around 80% of the euro area average, which limits the scope for faster convergence-driven growth. However, the country's growth potential remains constrained by high private sector leverage and non-performing loans (NPLs), keeping financial sector vulnerabilities, and their potential consequences for the sovereign, elevated.

**Potential upside from Brexit and offshore hydrocarbon deposits but risks from international tax initiatives**

Finally, Cyprus' medium-term growth outlook is likely to be affected by external political developments. While Brexit might be an opportunity for Cyprus to attract companies from the UK, we also point out the risk to Cyprus' role as a business and financial hub stemming from possible new international initiatives on corporate taxation or the retrenchment of cross-border financial intermediation by foreign banks. Conversely, Cyprus' economic outlook could be significantly boosted if the development of offshore hydrocarbon deposits proves financially viable and becomes operational without geopolitical risks materialising[1].

## Public finance risk

**Significant fiscal consolidation**

Cyprus' budget balance turned positive in 2016 – a significant turnaround from a deficit of around 9% of GDP in 2014 – which led to the country's exit from the EU's excessive deficit procedure in June 2016. Since then, fiscal performance has been very strong, with the general government balance recording a surplus of 1.8% of GDP in 2017, while the primary surplus increased to 4.3% of GDP, up from 3.1% of GDP in 2016. Going forward, we expect a primary surplus of slightly above 4% of GDP for 2018-20, slightly below the

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[1] European Commission, Post-programme surveillance report, Cyprus, Spring 2018.

government's 2018 Stability Programme[2] but among the highest in the EU. This will be driven on the one hand by solid revenues due to the strong economic recovery and ongoing labour market improvements and, on the other, by expenditures increasing at a comparatively slower pace.

However, we caution that this strong revenue performance may be temporary. Corporate income tax is inherently volatile and subject to relocation decisions by large companies, and the sizeable indirect tax receipts in 2017 of 15.6% of GDP, compared to 14.8% in 2013, benefitted from the buoyant construction sector and, to a lesser extent, from wholesale and retail trade. In addition, fiscal risks from the large financial sector remain intact, despite recent improvements following the sale of Cyprus Cooperative Bank (CCB), the second largest bank in the country, to Hellenic Bank, which resulted in a capital injection by the government of around EUR 3.5bn[3]. As a result, despite budgetary improvements leading to a significant fall in debt in 2017, to around 96% from 106% in 2016, we estimate public debt to increase to around 110% of GDP in 2018, based on IMF and European Commission data.

**High NPLs have become and could result in additional liabilities to the government**

In this context, Cyprus' debt trajectory – while benefiting from positive debt dynamics – in our view remains vulnerable to additional contingent liabilities from the financial sector. This is due to the still-too-high NPL levels and, following the CCB transaction, the substantial anticipated increase in government guarantees due to the large agreed asset protection scheme in favour of Hellenic Bank. In addition, we note that fiscal costs may increase due to announced healthcare reforms as well as public payroll growth. Conversely, future resources from hydrocarbon exploitation may further reduce government debt, strengthening the long-term sustainability of public finances[4].

## Debt sustainability analysis

**Elevated debt burden but favourable debt dynamics**

Our public-debt sustainability analysis, based on IMF forecasts and a combination of growth, interest-rate and primary-balance shocks, confirms that although Cyprus' debt trajectory still faces significant risks given the sizeable debt burden, a gradual decline is expected in the near future. On the basis of Cyprus' high debt level, expected primary surpluses going forward, and a further moderation in growth rates, our baseline scenario is for the debt-to-GDP ratio to decline from around 110% to around 80% by 2023. Despite this projected decline, debt-to-GDP will remain elevated, just below the IMF's debt burden benchmark for advanced economies (85%), but above the Maastricht criterion (60%). Cyprus thus remains vulnerable to macroeconomic and financial market shocks, indicating the need to maintain relatively high growth rates and a significant level of fiscal consolidation over multiple years.

**Small, illiquid bond market but prudent debt management operations**

Finally, we view positively Cyprus' active debt management operations, with a funding policy ensuring liquid assets coverage of the following nine-month period[5] and new issuance in euro and fixed-rate formats only[6]. This prudent approach also compensates for the country's small, illiquid and comparatively volatile bond market. However, the CCB transaction will increase debt amortisation during 2019-21 from around EUR 1.4bn (7% of GDP) to approximately EUR 2bn (10% of GDP). While these refinancing needs remain moderate, the low average maturity of outstanding debt securities – around 3.7 years, compared to Portugal's figure (6) or the euro area average (7) – exposes the sovereign to

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[2] According to the 2018 Stability Programme the headline and primary balances are respectively projected to reach 1.7% of GDP and 4.5% of GDP in 2018, and 1.7% of GDP and 4.7% of GDP in 2019.

[3] The transaction involved a private placement with the CCB in April and comprised the issuance of nine domestic government bonds for a total nominal amount of EUR 2.35bn with maturities of 15-20 years and yields of 2.45%-2.05%, the proceeds of which were deposited with the CBB along with a small cash addition from the government's cash buffer (EUR 0.15bn).

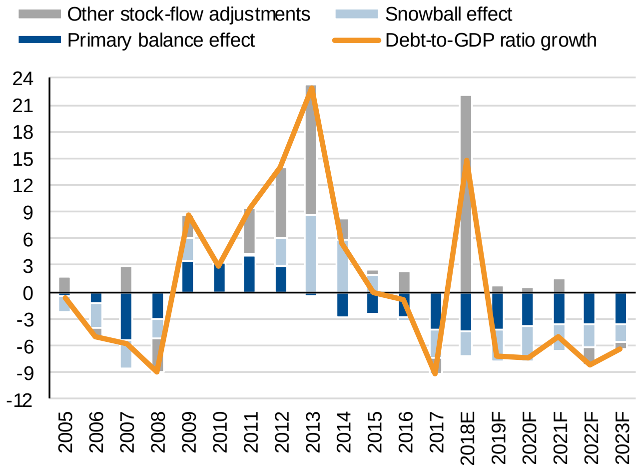
[4] European Commission, Post-programme surveillance report, Cyprus, Spring 2018.

[5] As of July 2018, coverage of the next 12 months debt redemptions stood at 68%.

[6] http://www.mof.gov.cy/mof/pdmo/pdmo.nsf/D02299346DAE4D5CC22580CD002E7277/$file/Investors%20presentation%20Cyprus%202018-09.pdf

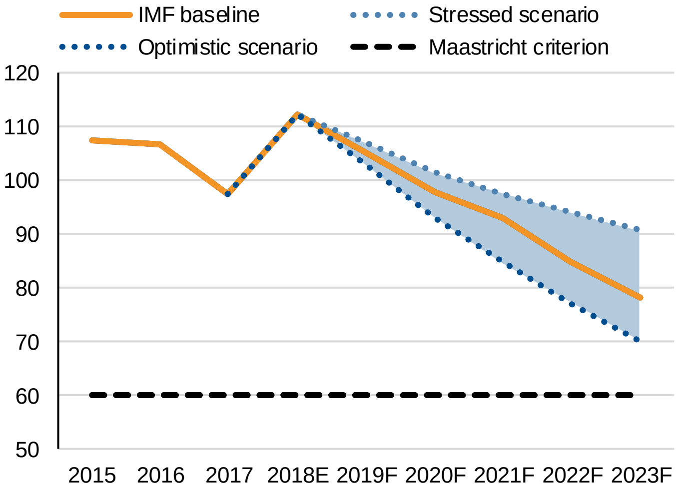
funding shocks. Still, we note that Cyprus benefits from its euro area membership as the sovereign can access – on a conditional basis – the ESM facilities, limiting market access vulnerabilities.

**Figure 2: Contribution to gov't debt changes, % of GDP**



Source: IMF, Scope Ratings GmbH

**Figure 3: General government debt, % of GDP**



Source: IMF, Scope Ratings GmbH
NB. These projections exclude the risk from banking-sector related contingent liabilities materialising on the government's balance sheet.

| Scenario | Period | Real GDP growth (%) | Primary bal. (% of GDP) | Real eff. int. rate (%) | Debt, end period (% of GDP) |
|---|---|---|---|---|---|
| **History** | **2013-17** | 0.4 | 2.6 | 3.5 | 97.5 |
| **IMF baseline** | **2018-23** | 3.2 | 3.9 | 0.3 | 78.2 |
| **Optimistic scenario** | | 4.2 | 4.4 | 0.3 | 70.0 |
| **Stressed scenario** | | 2.2 | 2.9 | 0.8 | 90.5 |

## External economic risk

**Large services surplus but goods deficit**

As a small economy with a large tourism industry and serving as a reginal financial hub and business centre, Cyprus consistently runs a large services-trade surplus (around 21% of GDP in Q2 2018) and a goods-trade deficit (around 22% of GDP in Q2 2018). In addition, it has a negative income account (around 5% of GDP), reflecting a large net negative international investment position (IIP) that results in net payments of dividends and interest (primary income) and remittances from foreign workers (secondary income). As a result, Cyprus' current account deficit stood at 6.6% of GDP in Q2 2018 (-8.4% in 2017), driven by a marked increase in imports that outpaced growth of exports. We expect this to persist, reflecting strong economic performance and the high import content of investment and consumption.

**Special purpose entities affect external statistics of Cyprus**

In addition, the increase in imports also reflects the registration of ships via special purpose entities (SPEs)[7] in Cyprus. These entities have large balance sheets relative to the size of the economy but minor real economic activity. Excluding these entities, the current account deficit would be smaller, by around 5pp.

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[7] SPEs comprise i) non-financial SPEs, mainly companies owning ships leased to third parties, with real assets on balance sheets matched by financial liabilities incurred to finance the ships' purchase; ii) financial companies which belong to an international group and channel funds between non-resident entities on behalf of their non-resident parent company, thus their financial assets match their financial liabilities; and iii) factoring or invoicing companies which invoice the sales of the worldwide group on behalf of the parent. IMF Article IV December2017.

**Very high external debt**

Successive current account deficits have led to a substantial negative net IIP of around 111% of GDP as of Q2 2018. However, this reflects a marked improvement compared to the net IIP deficit of around 150% in Q4 2014. In addition, adjusting for SPEs' net liabilities of around 75% of GDP, Cyprus' net IIP is significantly lower at around -36% of GDP. In our view, the size, composition, and structure of the international balance sheet may exacerbate risks stemming from the net IIP. In this context, Cyprus' role as a financial centre results in a very high level of external debt, around 500% of GDP, down since Q2 2010 (837%). Scope notes that, adjusted for the impact of SPEs, gross external debt stood at 270% of GDP as of Q2 2018 which is still significantly above that of peers such as Portugal (208%) or Spain (168%).

**Improving external debt composition**

Despite the large stock figures, the changing composition of external debt has lessened associated risks. The government and central bank's share of total external debt has increased (from around 8% in Q2 2010 to around 20% in Q2 2018) as well as the government's own figure (up from 22% of GDP to around 75%) due to the official loans, while the central bank's debt has decreased from 43% of GDP to around 3%, driven by the repayment of Eurosystem funding (Emergency Liquidity Assistance) over the same period. Notably, the share of external debt held by financial institutions has fallen from around 500% of GDP in Q2 2010 to around 82% in Q2 2018. Conversely, the external debt of other sectors, including SPEs, has remained steady at around 200% of GDP.

**International investment assets and liabilities mostly offset and relate to SPEs and FDI**

In addition, while gross financial flows are considerable relative to net positions and Cyprus' GDP (stocks of IIP assets and liabilities are respectively 13x and 14x GDP as of Q2 2018) these are associated with SPEs (mostly financial), mainly relate to foreign direct investment (about 70% of total assets and liabilities) and are largely offsetting[8]. In fact, the share of portfolio debt securities of Cyprus' foreign liabilities, whose non-contingent nature may complicate the absorption of shocks, remains very low at around 5% of GDP as of Q2 2018.

**External vulnerabilities mitigated by euro area architecture**

Overall, despite deleveraging and improvements in the composition and structure of Cyprus' international balance sheet, its negative net IIP is still high at around 111% of GDP, exposing the sovereign to shocks or sudden shifts in market sentiment. However, as noted previously, adjusted for the impact of SPEs, net IIP stood at around -36% of GDP in Q2 2018, which compares favourably with peers. In addition, it is our opinion that the strengthened euro-area architecture and the ECB's accommodative monetary stance markedly reduce such risks.

## Financial stability risk

**High, albeit declining, NPLs still weighing on bank profitability**

The banking sector remains fragile due to its large, albeit declining, stock of NPLs, which weighs heavily on the profitability and overall soundness of the banking sector. According to the Central Bank of Cyprus, the non-performing exposure (NPE) ratio peaked in July 2016 at 48.8% and has successively declined to 38.9% as of June 2018. This decline is due mostly to a reduction in NPEs in the corporate sector, by about EUR 8.2bn since the beginning of 2015, compared to a reduction of about EUR 2.7bn by households over the same period. The high NPE ratio despite the strong economic recovery points to structural problems in the financial sector and the need for further reforms aimed at improving payment discipline and the judiciary system.

However, we note positively that NPL provisioning has accelerated, with NPL coverage among Cypriot banks rising steadily to around 50%, slightly above the EU average of 44%. In addition, we highlight the government's efforts to strengthen the effectiveness of the legal framework related to NPE management and its burden-sharing scheme

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[8] IMF Article IV December 2017.

addressing the most challenging NPE portfolios, namely mortgages and SME loans (ESTIA Scheme[9]).

Still, as a result of high NPLs, the build-up of provisions[10], and shrinking interest margins, the banking sector as a whole continued to post losses in 2017, recording a negative return on equity of 7.4%. The successive losses have led to a decline in the Common Equity Tier 1 capital ratio of all banks, to 15.4% in Q2 2018 from 16.5% in Q4 2016. In terms of sector liquidity, however, the loan-to-deposit ratio has fallen significantly from its peak of 140% in January 2015 to around 90% in August 2018, a result of both deleveraging and a return of deposits. In fact, the level of deposits has increased by EUR 5.4bn, driven mostly by domestic residents since exiting the EU-IMF programme, reversing some of the significant outflow of around EUR 22bn between January 2013 and March 2016 (including the bail-in impact). In addition, the Emergency Liquidity Funding, which peaked at EUR 11.4bn in April 2013, was fully repaid by January 2017.

**Cyprus Cooperative Bank transaction strengthens banking system at direct fiscal cost to government**

Finally, in the summer of 2018, the Cypriot banking sector was further restructured through Hellenic Bank's acquisition of assets and liabilities from Cyprus Cooperative Bank (CCB), which was majority-owned by the government. Under the transaction, some of CCB's assets and liabilities will be integrated into Hellenic Bank, while the rest will remain in the CCB's residual entity, which has been authorised as a credit acquiring company and as a non-credit institution under the mortgage credit law, to be owned and financed by the government. After the legal transfer of EUR 8.34bn of CCB's assets to the residual entity, the size of the banking sector is estimated to fall from 321% to 280% of GDP. Notably, the transaction removed around EUR 6bn of CCB's non-performing exposures, around 30% of Cyprus' total NPEs. This, together with the sale of EUR 2.7bn of NPEs by the Bank of Cyprus to Apollo Fund, are likely to result in a 50% reduction in NPLs by year-end[11].

However, the shift of NPEs, as well as the associated financial costs and risks taken on by the residual entity, has not only had a direct fiscal impact on the government but also led to an increase in the sovereign's exposure to the financial sector. Specifically, the government injected around EUR 3.5bn of funds to absorb losses made by the residual entity, raising the public debt-to-GDP ratio to around 110% in 2018[12]. Moreover, contingent liabilities in the form of government guarantees are expected to increase substantially due to the large agreed asset protection scheme in favour of Hellenic Bank.

**Elevated sovereign-banking nexus pointing to need for high capital and fiscal buffers**

We therefore note that while the transaction has improved the soundness of the banking sector and thus it is anticipated that it will contribute to the flow of credit in the economy, and therefore also strengthening investor confidence, it also reinforces the link between the sovereign and the country's large financial sector. This raises the need for countercyclical bank capital buffers to reduce the probability and magnitude of shocks that originate in the financial sector as well as strong fiscal buffers to absorb eventual crises[13]. In this context, while the countercyclical capital buffer requirement is still 0%, we note positively that the central bank of Cyprus has designated six credit institutions as Other Systemically Important Institutions and imposed capital buffers to be phased in over 2019-22[14].

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[9] With the anticipated introduction of ESTIA, the State will provide financial assistance to participating borrowers, covering one-third of their restructured loan repayment obligations provided they fulfil a number of income and asset criteria.

[10] Increased provisioning reduces profits not only directly, but also indirectly by reducing the non-provisioned part of NPLs on which banks accrue interest income.

[11] European Commission, Post-programme surveillance report, Cyprus, Spring 2018 and Cyprus Investor Presentation September 2018.

[12] This assessment is based on European Commission and IMF data. The Cypriot authorities estimate that the transaction will result in a one-off increase of public debt by about EUR 3.19bn, raising the debt-to-GDP ratio to around 104% by year-end. Investor Presentation September 2018.

[13] https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2177.en.pdf

[14] 0.5% for Alpha Bank and Euro bank, 1% for Hellenic Bank, 1.5% for RCB, and 2% for Bank of Cyprus. CCB's buffer was also set at 1% prior to the acquisition. https://www.centralbank.cy/images/media/redirectfile/O-SII_institutions_%20and_O-SII_buffer_CI%20-%202017_.pdf

## Institutional and political risk

**Sound political institutions**

Cyprus joined the EU in 2004 (and the euro area in 2008) and has fully adopted the EU's regulatory framework, providing an anchor for institutional stability and predictability. In our view, Cyprus is as likely as any EU member to honour debt obligations in full and on time. Cyprus' request for an EU-IMF financial assistance package in March/April 2013, its clean exit from the programme in March 2016, and the subsequent successful post-programme monitoring reviews speak to its willingness to repay creditors on time.

Cyprus has a system of government whereby the president is both head of state and head of government, elected directly by the citizens every five years in the middle of the legislative term. The Cypriot parliament (house of representatives[15]) is elected via separate elections, also held every five years, through which the elected president's party usually forms a coalition government with smaller parties.

Nicos Anastasiades, head of the conservative Democratic Rally party, is the current president, the seventh in Cyprus' history. He was re-elected for another five-year term on 4 February 2018 following a run-off presidential election in which his party won the majority of the votes with 56%. Until the next legislative election (due May 2021) and the next presidential elections (February 2023) we expect the government to continue focusing on fiscal consolidation, attracting foreign investments, and addressing the high NPL levels and associated fragilities in the banking sector.

In this context, the European Commission highlights the need to i) enhance the economy's growth potential by improving the business environment to attract further growth-enhancing investments; and ii) comprehensively reform the justice system, expected to be finalised in 2020, given its impact on the economy and its strong link to NPL reduction.

**Ongoing geopolitical tensions on divided island**

Finally, we note that the division of Cyprus – between the mainly Greek-speaking south and the mainly Turkish-speaking north for over four decades[16] – remains a key geopolitical issue. While President Anastasiades and Turkish Cypriot leader Mustafa Akinci are determined to reach a sustainable solution to reunify the island, the complexity of the matter was again highlighted with Turkey's intervention in the Eastern Mediterranean and the Aegean Sea, blocking exploratory drillings by energy company Eni on Greek-Cypriot territory[17].

## Methodology

The methodology applicable for this rating and/or rating outlook 'Public Finance Sovereign Ratings' is available on www.scoperatings.com. Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com. The rating Outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

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[15] The house of representatives is composed of 56 members from the Greek Cypriot community. Another 24 seats are reserved for Turkish Cypriot community members, but these have been vacant since 1964. Three observer members represent the Armenian, Latin and Maronite minorities.

[16] The population of the southern two-thirds of the island, controlled by the government of the Republic of Cyprus, is almost entirely Greek Cypriot, while the population of the northern third, controlled by the Turkish-Cypriot Administration (whose sovereignty is recognised only by Turkey) comprises Turkish Cypriots, settlers from the Turkish mainland and around 42,000 Turkish troops.

[17] http://www.consilium.europa.eu/media/33457/22-euco-final-conclusions-en.pdf

## Rating history

| | Rating action | Outlook |
|---|---|---|
| 19 October 2018 | First-time rating: BBB- | Stable |

Source: Scope Ratings GmbH

## Outlook and rating-change drivers

The Stable Outlook reflects our assessment that the risks faced by Cyprus remain balanced at this stage.

The rating could be upgraded if: i) the banking sector is further strengthened; ii) the public debt stock is reduced in a sustained manner; and/or iii) the government negotiates a sustainable solution to its geopolitical risks (reunification of the island).

Conversely, the rating could be downgraded if: i) public finances deteriorate due to a reversal of fiscal consolidation; ii) there is a fading commitment to or a reversal of structural reforms, including judiciary reform, leading to an adverse impact on the medium-term economic and fiscal outlook; and/or iii) banking sector fragilities re-emerge in the form of additional liabilities to the government.

### Foreign- versus local-currency ratings

Cyprus has almost no foreign-currency-denominated public debt. Consequently, we see no reason to believe that Cyprus would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

### Rating Committee

The main points discussed were: i) Cyprus' growth potential; ii) macroeconomic stability and sustainability; iii) fiscal consolidation, contingent liabilities, public debt sustainability, debt structure and market access; iv) external debt sustainability and vulnerabilities, including through SPEs; v) banking sector challenges; vi) political developments; and vii) peers.

## I. Appendix: Environmental, social and governance (ESG) factors

We consider ESG sustainability issues during the rating process as reflected in our sovereign methodology. Governance-related factors are explicitly captured in our assessment of 'Institutional and Political Risk', for which Cyprus scores moderately according to the World Bank's Worldwide Governance Indicators. Qualitative governance-related assessments in the 'recent events and policy decisions' and 'geo-political risk' categories of our QS are assessed as 'neutral' and 'weak' compared with Cyprus' sovereign peers.

Socially related factors are captured in our CVS in Cyprus' moderate GDP per capita (USD 25,380 in 2017) and falling level of unemployment but moderately high old-age dependency ratio. Qualitative assessments of social factors are reflected in the section 'macroeconomic stability and sustainability', for which we assess Cyprus to be 'weak'. Finally, environmental factors are considered during the rating process but did not have an impact on this rating action.

## II. Appendix: CVS and QS results

### Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, signals an indicative 'BBB' ('bbb') rating range for the Republic of Cyprus. Scope affirms the indicative rating of 'bbb' for the Republic of Cyprus. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative findings. For the Republic of Cyprus, the following relative credit strength has been identified: i) resilience of current account. Relative credit weaknesses are: i) macro-economic stability and sustainability; ii) debt sustainability; iii) market access and funding sources; iv) external debt sustainability; v) vulnerabilities to short-term external shocks; vi) geopolitical risk; vii) banking sector performance; and viii) financial imbalances and financial fragility. The combined relative credit strengths and weaknesses generate a one-notch adjustment and signal a sovereign rating of BBB- for the Republic of Cyprus. A rating committee has discussed and confirmed these results.

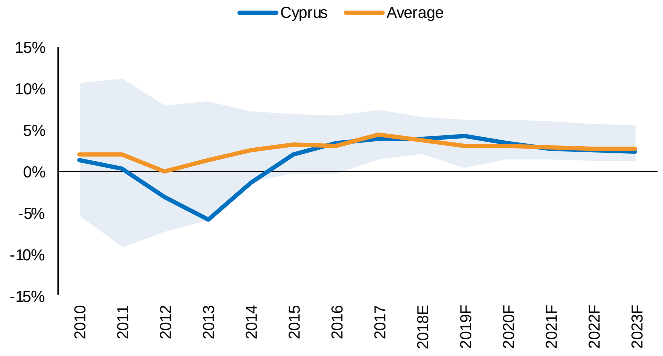
| CVS | | QS | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | *Maximum adjustment = 3 notches* | | | |
| Rating indicator | Category weight | | +2 notch | +1 notch | 0 notch | -1 notch | -2 notch |
| **Domestic economic risk** | **35%** | Growth potential of the economy | ○ Excellent outlook, strong growth potential | ○ Strong outlook, good growth potential | ● Neutral | ○ Weak outlook, growth potential under trend | ○ Very weak outlook, growth potential we under trend or negative |
| Real GDP growth<br>Real GDP volatility<br>GDP per capita<br>Nominal GDP<br>Inflation rate | | Economic policy framework | ○ Excellent | ○ Good | ● Neutral | ○ Poor | ○ Inadequate |
| Unemployment rate<br>Old-age dependency ratio | | Macro-economic stability and sustainability | ○ Excellent | ○ Good | ○ Neutral | ● Poor | ○ Inadequate |
| **Public finance risk**<br>Primary balance | **30%** | Fiscal policy framework | ○ Exceptionally strong performance | ○ Strong performance | ● Neutral | ○ Weak performance | ○ Problematic performance |
| Interest payments | | Debt sustainability | ○ Exceptionally strong sustainability | ○ Strong sustainability | ○ Neutral | ● Weak sustainability | ○ Not sustainable |
| Gross debt<br>Gross financing needs | | Market access and funding sources | ○ Excellent access | ○ Very good access | ○ Neutral | ● Poor access | ○ Very weak access |
| **External economic risk**<br>External debt | **15%** | Current account vulnerability | ○ Excellent | ● Good | ○ Neutral | ○ Poor | ○ Inadequate |
| Currency turnover/reserves | | External debt sustainability | ○ Excellent | ○ Good | ○ Neutral | ● Poor | ○ Inadequate |
| Net international investment position (NIIP)<br>Current account balance | | Vulnerability to short-term external shocks | ○ Excellent resilience | ○ Good resilience | ○ Neutral | ● Vulnerable to shock | ○ Strongly vulnerable to shocks |
| **Institutional and political risk** | **10%** | Perceived willingness to pay | ○ Excellent | ○ Good | ● Neutral | ○ Poor | ○ Inadequate |
| World Bank Worldwide Governance Indicators | | Recent events and policy decisions | ○ Excellent | ○ Good | ● Neutral | ○ Poor | ○ Inadequate |
| | | Geopolitical risk | ○ Excellent | ○ Good | ○ Neutral | ● Poor | ○ Inadequate |
| **Financial risk** | **10%** | Banking sector performance | ○ Excellent | ○ Good | ○ Neutral | ● Poor | ○ Inadequate |
| Non-performing loans (NPLs)<br>Tier 1 ratio | | Banking sector oversight and governance | ○ Excellent | ○ Good | ● Neutral | ○ Poor | ○ Inadequate |
| Credit to GDP gap (bubble)<br>Credit to GDP gap (imbalance) | | Financial imbalances and financial fragility | ○ Excellent | ○ Good | ○ Neutral | ● Poor | ○ Inadequate |
| **Indicative rating range** | **bbb** | | | | | | |
| **QS adjustment** | **-1** | | | | | | |
| **Final rating** | **BBB-** | | | | | | |

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings GmbH

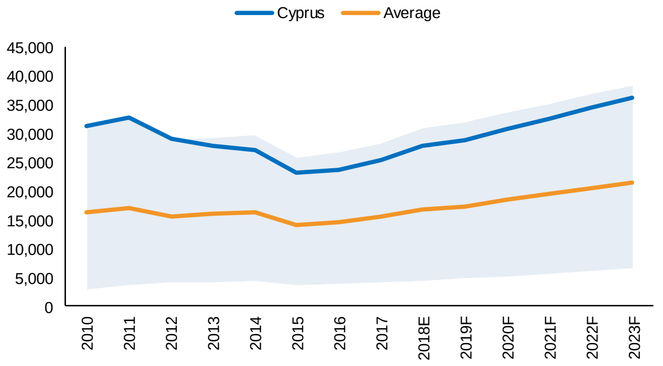
## III. Appendix: Peer comparison

### Figure 4: Real GDP growth



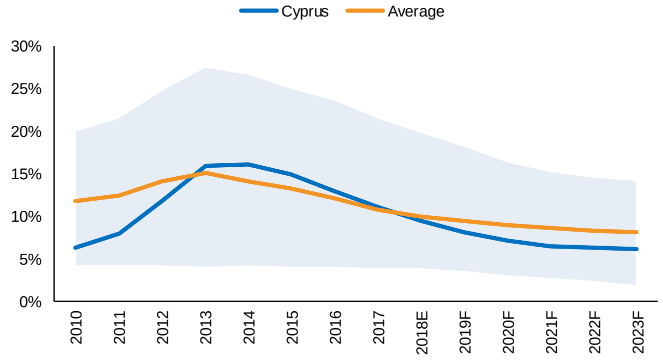
Source: IMF, calculations Scope Ratings GmbH

### Figure 5: GDP per capita, USD



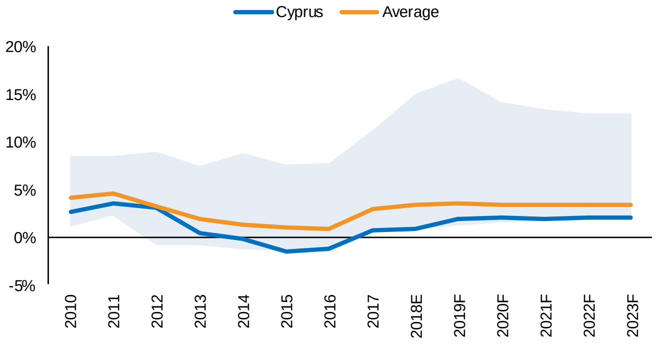
Source: IMF, calculations Scope Ratings GmbH

### Figure 6: Unemployment rate, %



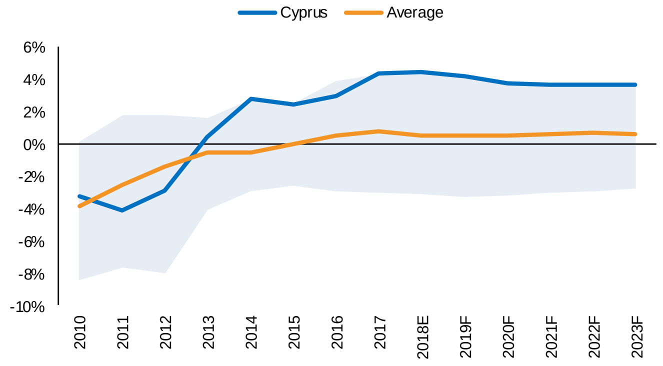
Source: IMF, Calculations Scope Ratings GmbH

### Figure 7: Headline inflation, %



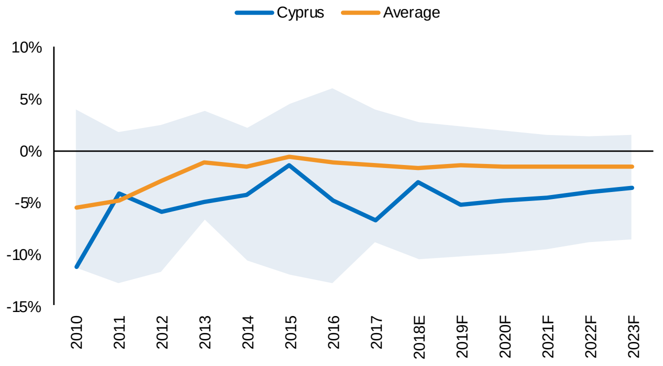
Source: IMF, Calculations Scope Ratings GmbH

### Figure 8: General government primary balance, % of GDP



Source: IMF, Calculation Scope Ratings GmbH

### Figure 9: Current account balance, % of GDP



Source: IMF, Calculation Scope Ratings GmbH

## IV. Appendix: Statistical tables

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018E | 2019F |
|---|---|---|---|---|---|---|---|
| **Economic performance** | | | | | | | |
| Nominal GDP (EUR bn) | 18.1 | 17.6 | 17.7 | 18.5 | 19.6 | 20.4 | 21.6 |
| Population ('000s) | 866.0 | 858.0 | 847.0 | 848.0 | 855.0 | 860.0 | 865.0 |
| GDP per capita PPP (USD) | 30,620.7 | 30,383.5 | 31,523.9 | 32,707.9 | 34,503.5 | - | - |
| GDP per capita (EUR) | 20,950.8 | 20,519.7 | 20,946.9 | 21,476.7 | 22,477.5 | 23,493.9 | 24,685.2 |
| Real GDP, % change | -5.9 | -1.4 | 2.0 | 4.8 | 4.2 | 4.0 | 4.2 |
| GDP growth volatility (10-year rolling SD) | 3.8 | 3.6 | 3.5 | 3.4 | 3.3 | 3.3 | 3.4 |
| CPI, % change | 0.4 | -0.3 | -1.5 | -1.2 | 0.7 | 0.8 | 1.8 |
| Unemployment rate (%) | 15.9 | 16.1 | 14.9 | 13.0 | 11.1 | 9.5 | 8.0 |
| Investment (% of GDP) | 13.1 | 12.2 | 13.7 | 16.7 | 20.5 | 17.0 | 19.6 |
| Gross national savings (% of GDP) | 8.2 | 8.0 | 12.8 | 11.9 | 13.7 | 13.9 | 14.4 |
| **Public finances** | | | | | | | |
| Net lending/borrowing (% of GDP) | -3.3 | -0.2 | -0.2 | 0.4 | 1.8 | 2.1 | 1.6 |
| Primary net lending/borrowing (% of GDP) | 0.4 | 2.8 | 2.5 | 2.9 | 4.3 | 4.5 | 4.2 |
| Revenue (% of GDP) | 37.7 | 39.8 | 39.0 | 38.6 | 39.7 | 39.3 | 39.1 |
| Expenditure (% of GDP) | 41.0 | 40.0 | 39.2 | 38.2 | 37.9 | 37.2 | 37.6 |
| Net interest payments (% of GDP) | 3.7 | 3.0 | 2.6 | 2.5 | 2.5 | 2.4 | 2.6 |
| Net interest payments (% of revenue) | 9.8 | 7.6 | 6.8 | 6.5 | 6.4 | 6.1 | 6.7 |
| Gross debt (% of GDP) | 102.1 | 107.5 | 107.5 | 106.6 | 97.5 | 112.3 | 105.1 |
| Net debt (% of GDP) | 78.6 | 89.5 | 91.3 | 88.2 | 81.5 | - | - |
| Gross debt (% of revenue) | 270.8 | 270.0 | 275.7 | 276.3 | 245.3 | 286.0 | 268.6 |
| **External vulnerability** | | | | | | | |
| Gross external debt (% of GDP) | 569.1 | 554.3 | 572.6 | 576.5 | 554.5 | - | - |
| Net external debt (% of GDP) | 140.0 | 136.1 | 148.2 | 130.6 | 144.3 | - | - |
| Current account balance (% of GDP) | -4.9 | -4.3 | -1.5 | -5.0 | -8.4 | -3.1 | -5.2 |
| Trade balance (% of GDP) | -16.2 | -16.0 | -16.7 | -21.0 | -24.3 | -25.0 | -25.7 |
| Net direct investment (% of GDP) | -1.7 | -7.9 | 47.4 | -9.8 | -23.2 | - | - |
| Official forex reserves (EOP, EUR m) | 55.0 | 61.0 | 73.0 | 69.0 | 60.0 | - | - |
| REER, % change | 1.0 | -0.7 | -6.4 | -0.3 | 0.2 | - | - |
| Nominal exchange rate (EOP, USD/EUR) | 1.4 | 1.2 | 1.1 | 1.1 | 1.2 | - | - |
| **Financial stability** | | | | | | | |
| Non-performing loans (% of total loans) | 38.6 | 45.0 | 47.7 | 48.7 | 40.2 | - | - |
| Tier 1 ratio (%) | 12.3 | 14.6 | 16.0 | 16.4 | 15.4 | - | - |
| Consolidated private debt (% of GDP) | 340.1 | 352.4 | 353.5 | 337.7 | 314.4 | - | - |
| Domestic credit-to-GDP gap (%) | -4.5 | -6.4 | -12.4 | -30.4 | -53.3 | - | - |

Source: IMF, European Commission, European Central Bank, Central Bank of Cyprus, World Bank, Haver Analytics, Scope Ratings GmbH

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