# Research Report on Cyprus

5 April 2019

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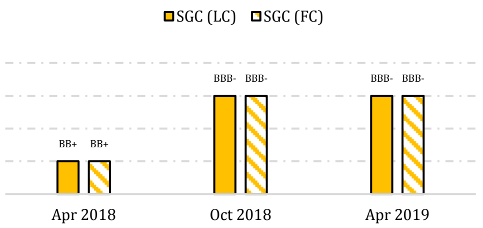
**Ratings**

| | |
|---|---|
| Sovereign Government Credit (LC) | BBB- |
| Sovereign Government Credit (FC) | BBB- |
| Outlook (LC) | Stable |
| Outlook (FC) | Stable |

* These ratings are unsolicited

**Ratings dynamics**




**Main Economic Indicators of Cyprus**

| Macro indicators | 2016 | 2017 | 2018 |
|---|---|---|---|
| Gross gov. debt, EUR bn | 19,4 | 18,7 | 21,4 |
| Nominal GDP, EUR bn | 18,2 | 19,2 | 20,2 |
| Real GDP growth, % | 3,4 | 3,9 | 4,2 |
| Gross gov. debt/GDP, % | 106,6 | 97,5 | 106,1 |
| Deficit (surplus)/GDP, % | 0,4 | 1,8 | 2,1 |
| Inflation rate, % | 0,1 | -0,4 | 2,4 |
| Current Account Balance/GDP, % | - | - | -4,1 |
| External gov. debt, EUR bn | - | - | 17,5 |

| Development indicators | 2018 |
|---|---|
| Inequality adj. HDI | 0,77* |
| GDP per capita, USD th | 39,1 |

| Default indicator | 05.04.2019 |
|---|---|
| 9Y Gov Bond Yield, % | 1,53 |

Source: RAEX-Europe calculations based on data from the IMF, WB, Ministry of Finance, UN, Cbonds. *Data as of 2017.

## Summary

The Agency confirmed the ratings of Cyprus at 'BBB-' based on solid economic growth, together with significantly lower share of distressed loans in the banking system and further progress in the fiscal position. Moreover, the unemployment reached its lowest level in five years and continues to constantly decline. Investment attractiveness improved, with positive net FDI flow due to the boost in construction sector. Despite high fiscal costs of the government's intervention in Cyprus Cooperative Bank (CCB), we believe that public debt is well structured and will turn back to a declining path.

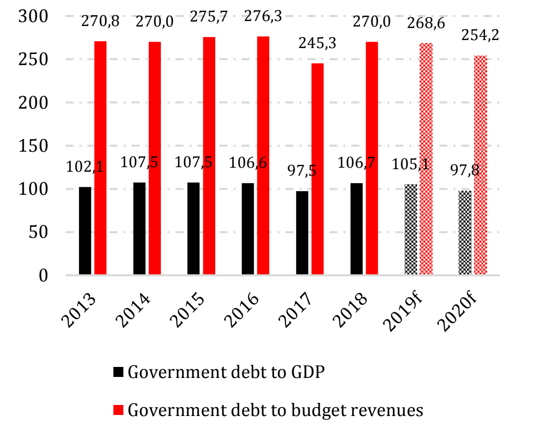
However, banks' weak asset quality together with insufficient diversification of the economy are the main downside factors for the creditworthiness of the sovereign.

**Government debt metrics are adequate.** After the remarkable drop of government debt to GDP in 2017 below 100%, it increased by 11% in 2018 reaching more than 106% of GDP and 270% of budget revenues (see graph 1). Such hike is associated with the troubled Cyprus Cooperative Bank (CCB) liquidation. Total fiscal costs for the government to support the bank were nearly EUR 3,5 bn in form of bonds and government deposits placed on the assets and liabilities sides of CCB respectively. We consider this government provision as a one-time effect and expect debt metrics to resume a downward trend maintained by solid economy growth.

Public debt continues to be well structured and payment schedule adequately managed. Just 1% of the debt, by original maturity at issue, is short term and only 4,6% of total obligation required to be paid within one year in 2019. In addition, 97% is denominated in local currency and 61% has fixed interest rate. Additionally, the debt with free-floating interest rate is mostly provided by the European Stability Mechanism on concessional terms.

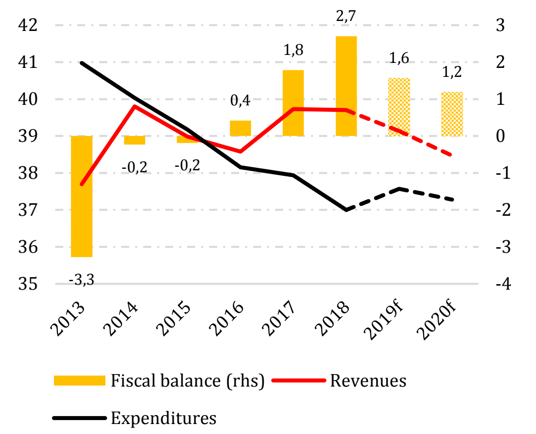
**Budget balance was positive in 2018 and we anticipate surpluses to continue.** The fiscal position has strengthened with already third year surplus widening to 2,7% of GDP in 2018 (see graph 2). Main drivers were stronger than predicted revenues from indirect taxes, specifically VAT, which was 5% higher than a year before in nominal terms. We anticipate

**Graph 1:** Government debt dynamics, %



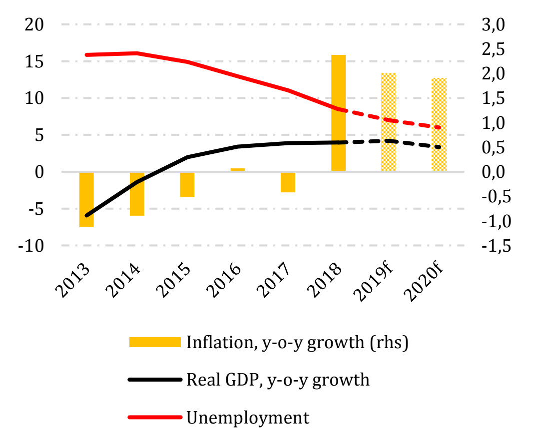

Source: RAEX-Europe calculations based on data from the IMF

**Graph 2:** Fiscal budget dynamics, % of GDP




Source: RAEX-Europe calculations based on data from the IMF

**Graph 3:** Macroeconomic indicators, %




Source: RAEX-Europe calculations based on data from the IMF

the indicator to improve even further if strict fiscal discipline is maintained and internal control advances. However, the introduction of National Health Scheme in 2020 might significantly elevate government expenditure.

**Macroeconomic position improved further.** The macroeconomic performance of Cyprus shows progressing recovery from the crisis as real GDP grew by 4,2% and GDP per capita at PPP terms remained strong at USD 39 100 in 2018. We expect that Cypriot economy to grow in 2019 at a similar pace as in 2018 mainly supported by private consumption increase (see graph 3).

Cyprus' unemployment declined by 2,6p.p. y-o-y down to 8,5% in 2018, achieving the lowest rate recorded since 2013. Moreover, there was a positive change in the youth unemployment ratio as well (4,1p.p. down till 20,6% in 4Q 2018). We expect the figure to continue to decline in 2019 even though the job mismatch issue is still yet to be resolved. On the other hand, the average for the year part-time employment remained high at around 12%, and 8% of total employment is related to construction that most certainly is only a temporary activity.

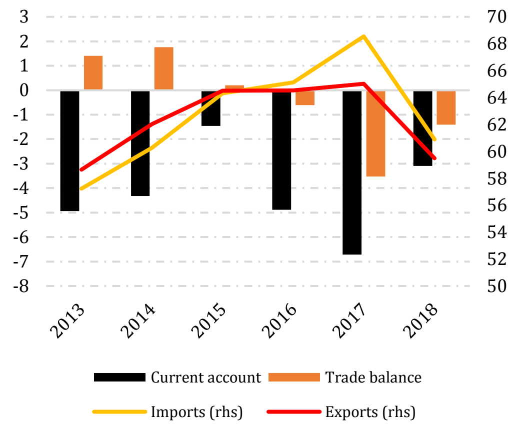
Inflation pressure continues to be low. The Harmonized Index of Consumer Prices (HICP) reached its projected level of 2,4% in 2018 mainly pushed by rising food, housing and energy prices, but remained lower than the average in Euro area.

**Investment attractiveness improved, external positon remains challenging**. Economic activity continues to be concentrated in tourism and wholesale. At the end of the year, more than 23% of total GDP was related to retail, accommodation and food services and 10% to real estate activities. According to the Global Competitiveness Index report Cyprus is ranked 44$^{th}$ out of 140 countries (45$^{th}$ in 2017) constrained by small market size and financial system condition.

The current account deficit is expected to widen due to the higher import level on construction related industry as well economic slowdown of main trading partners (around 40% of total goods and services export goes to United Kingdom and Russia). At the end of 2018, the trade balance remained negative at -1,5% of GDP (see graph 4).

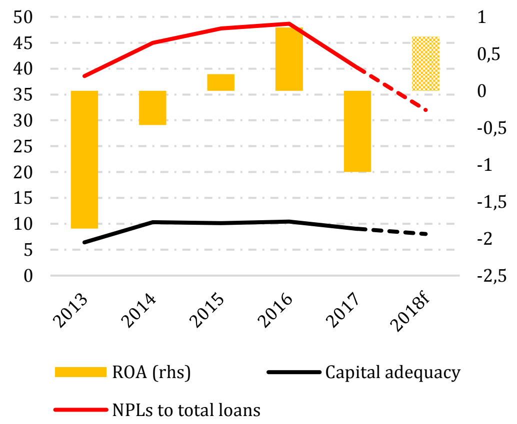
The net international investment position (NIIP) of the country improved further as of 2Q 2018 when it stood at -109% of GDP compared to end-2017 (-120% of GDP). Despite this, Cyprus remains at the bottom of the EU net investment list. We expect gradual growth of FDI in coming years determined by a range of government incentives, such as the Citizenship

**Graph 4:** External sector indicators, % of GDP




Source: RAEX-Europe calculations based on data from the IMF and WB

**Graph 5:** Financial soundness indicators, %




Source: RAEX-Europe calculations based on data from the Central Bank of Cyprus

by Investment Scheme. However, on 13 February 2019 the Council of Ministers of the Republic of Cyprus approved Cypriot Investment Scheme (that will substitute the Citizenship by Investment Scheme) in order to stimulate long term social development. On the other hand, that might negatively impact real estate investment as conditions of getting permanent residence and citizenship will be tightened.

**Deleveraging and restructuring of the banking sector continues.** Cyprus' banking sector development continues to be constrained by substantially high level of NPLs to total loans ratio, around 33% at the end of 2018. Significant improvement of the indicator, from 40% year earlier, was mostly driven by sales of non-performing loans of several Cyprus' banks (Bank of Cyprus, Hellenic Bank, CCB). The largest sell of EUR 6 bn of CCB's NPLs was placed in the balance sheet of the credit acquiring entity Cyprus Asset Management Company who will further perform reclassifications, debt to assets swaps and write-offs. Simultaneously, the performing assets of CCB were purchased by Hellenic bank. An after-effect of the transfer of the total amount of EUR 10,3 bn under the balance sheet of Hellenic bank is the additional concentration of the Cypriot banking sector. At the end of 2018, the three largest banks hold up to 80% of total assets, around 20p.p. higher than a year before. At the same time, profitability of banks improved with a positive value of ROA indicator of 0,7% as of 3Q 2018 in comparison with -1,2% for the same period in 2017. Capital adequacy ratio decrease by 1p.p. y-o-y to 8% as systemic risk is decreasing (see graph 5).

Deleveraging policy of the government is progressing as banks' asset to GDP ratio dropped down to 294% in 2018 from 350,5% in previous year and total balance value of loans provided to domestic residents reduced by 24% in absolute terms according to our estimations. Mainly, this could be explained by debt write-offs and loans transfer, considering that pure new loans to households slightly increased by 0,6% y-o-y in 3Q 2018. Nonetheless, asset to GDP ratio remains the highest among its euro peers[1]. We expect more loans to households to be issued by the banking system in 2019 as lending rates continue to drop (interest rates on euro-denominated loans on average decreased by 40b.p.).

[1]Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

**Important note for sovereign ratings**

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Cyprus_05.04.2019.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.