Research Report on Cyprus

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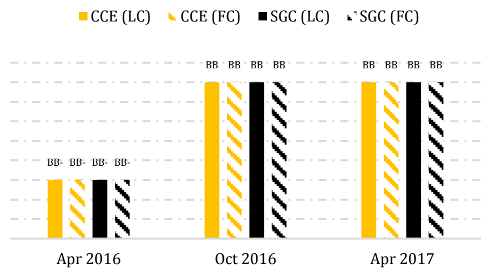
Ratings

Sovereign Government Credit (LC)	BB
Sovereign Government Credit (FC)	BB
Country Credit Environment (LC)	BB
Country Credit Environment (FC)	BB

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Cyprus

Macro indicators	2014	2015	2016
Gross gov. debt, EUR bn	18,8	19,0	19,0*
Nominal GDP, EUR bn	17,4	17,4	17,9
Real GDP growth, %	-2,5	-1,5	2,8
Gross gov. debt/GDP, %	108,2	108,9	106,7*
Deficit (surplus)/GDP, %	-0,2	-1,4	-0,5*
Inflation rate, %	-1,4	-2,1	-1,4
Current Account Balance/GDP, %	-4,6	-3,6	-1*
External debt, USD bn	-	-	113,7

Development indicators	2016
Inequality adj. HDI	0,762
GDP per capita, USD th	34,4

Default indicator	07.04.2017
10Y Gov Bond Yield, %	3,22

Source: RAEX (Europe) calculations based on data from the IMF, WB, Ministry of Finance, UN. * Forecast for 2016

Summary

Better than expected economic growth due to an increase in consumption and tourism activities together with further stabilization of the banking sector support our confirmation of Cyprus' ratings at 'BB'. Additionally, the fiscal gap narrowed further, inflation turned to positive territory.

On the other hand, still substantially high levels of government and private debt, lingering banking sector risks and elevated external exposure through trade, continue to negatively affect the rating. Nonetheless, all these metrics have shown a favorable trend.

Thus, a sustained consolidation of the positive factors and continued improvement of the current negative variables, could lead to a rating upgrade in our next revision.

Declining trend of government debt is expected in the upcoming years. Government debt stood at around 106% of GDP in 2016, declining by 2,4p.p. as compared to a year before, due to better than expected GDP growth. Moreover, debt to budget revenues continued its reduced growth pace as they increased slightly by 3,1p.p. up to 283% as of end-2016. However, even with these debt levels, Cyprus is below the average of its euro peers[1] (see table 1). We can anticipate further reduction in the debt metrics in the upcoming years given encouraging prospects of the fiscal policy and expected solid economic growth (see graph 1).

Table 1: Peer comparison for 2016

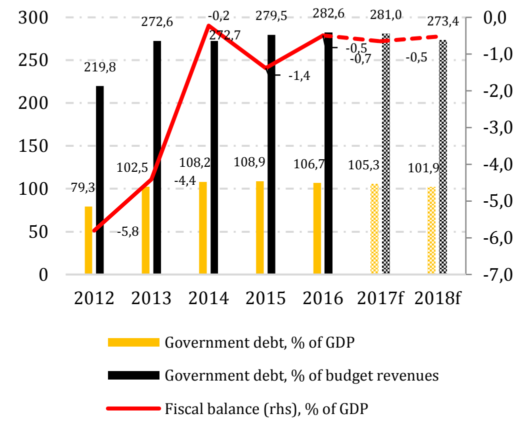
Key Financial Ratios	Cyprus	Greece	Italy	Portugal	Spain
GDP growth (%)	2,8%	0,6%*	0,75%*	1%*	3%*
Inflation rate (%)	0,1%	-0,11%*	-0,56%*	2,3%*	0,6%*
Fiscal balance/GDP	-0,5%	-3,3%*	-2,4%*	-2,9%*	-4,4%*
Current account/GDP	-1%*	-0,03%*	2,17%*	0,02%*	1,9%*
Government debt/GDP	106,7%	183,4%*	133,2%*	127,9%*	99,0%*
Unemployment rate	13%	22,3%*	11,4%*	11,1%*	19,4%*

Source: RAEX (Europe) calculations based on data from the IMF and WB.
* IMF projections

The debt structure remained strong. As of end of 2016, short-term debt stayed low and sustainable at 3,25% of GDP and 8,6% of budget revenues and represented only 3% of the total debt. In terms of currency and type of debt, the debt portfolio kept the same structure with 95% of the total

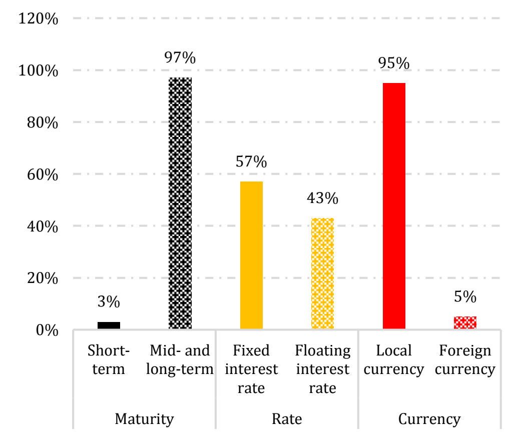
[1] Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

Graph 1: Government debt and public finance dynamics



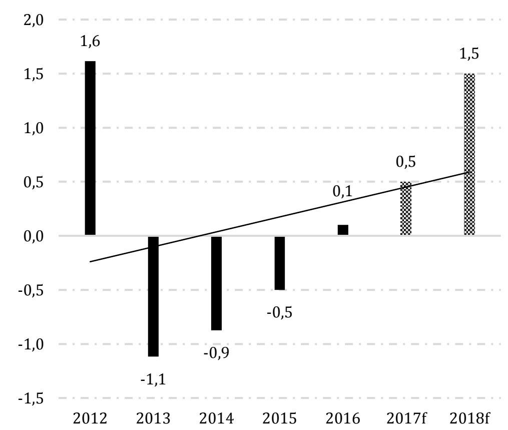
Source: RAEX (Europe) calculations based on data from the IMF

Graph 2: Debt structure as of December 2016



Source: RAEX (Europe) calculations based on data from the Ministry of Finance

Graph 3: Harmonized CPI, % y-o-y



Source: RAEX (Europe) calculations based on data from the IMF

debt denominated EUR and 66% in the form of official loans. Nonetheless, the share of debt with floating interest rate remains slightly high and accounts for 43% of total debt, a reduction of 3p.p from 2015 (see graph 2). The government guarantees amounted around 9% of GDP, as of first half of 2016 compared to 15% in 2015.

The fiscal stance improved further and is expected to remain strong. The fiscal deficit narrowed from 1,4% of GDP in 2015 to 0,5% as of end-2016 (see graph 1). The improvement in the fiscal stance is due to strong economic growth, which has been translated into favorable tax collection, and controlled expenditures which include reduced spending for pensions and transfers to local governments.

As mentioned above, the consistency on the positive fiscal performance will depend on the willingness of the government to stick with the current privatization and public spending plan considering that presidential elections are planned to be held in early 2018.

Economic growth continues and is expected to remain solid. After a growth of 1,5% in 2015, the Cypriot economy grew by a strong 2,8% in 2016. The drivers were the same as in the previous year namely, private consumption fueled by low prices and strong tourist activity. The sectors which grew considerably in 2016 were construction (9%) and accommodation and food service activities (10%) which are linked to the positive dynamics in tourism. The financial sector contributed negatively to GDP growth in 2016 contracting by 5% compared to 2015.

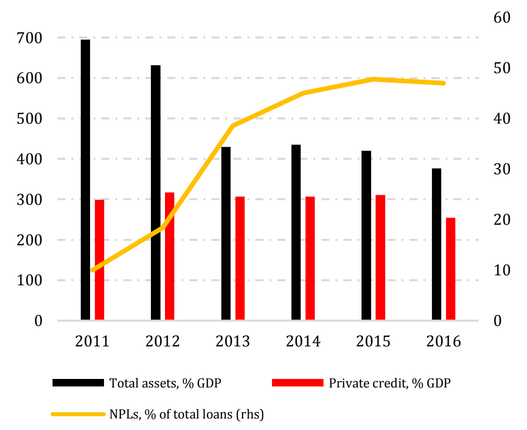
The unemployment rate dropped in 2016 to 13% and youth unemployment went down below 30% for the first time since 2012. Despite the declining trend and the fact that Cyprus has lower unemployment rate than average of its euro peers, unemployment can still be considered as significant.

Inflation, as expected in our previous report[2] returned to positive territory as of December 2016 and stood at 0,1%; it remained positive in the first two months of 2017. The positive dynamics was mostly driven by an increase in housing, water, electricity and gas prices, but also food and transport prices. We expect the inflation to continue to increase consistently and moderately in 2017 (see graph 3).

External position of Cyprus remains challenging in 2016. As of 4Q 2016 gross external debt stood at EUR 106 bn, which represents an increase compared to 2015 (EUR 98 bn), and amounted around 685% of GDP, which is the highest value since 2012.

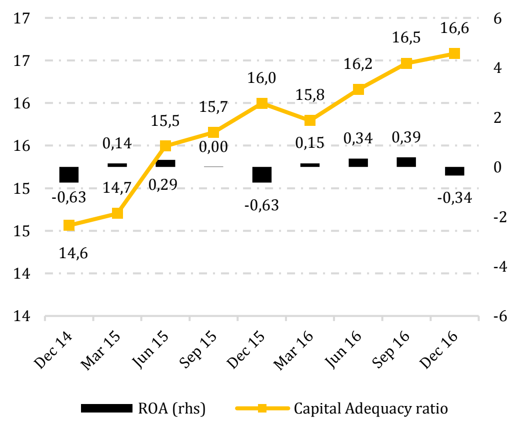
[2] http://raexpert.eu/reports/Research_report_Cyprus_14.10.2016.pdf

Graph 4: Banking sector size and NPLs dynamics



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

Graph 5: Banking system metrics, %



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

According to the latest IMF forecast, the current account balance as of end-2016 will remain negative at around -1% of GDP. However, as of end of 2016, the country recorded a very narrow trade surplus of 0,002% of GDP. The net international investment position (NIIP) of the country slightly improved as of 3Q 2016 when it stood at -118% of GDP compared to the corresponding period of the previous year (-133% of GDP). Despite the improvement, Cyprus remains at the bottom of the EU net investment list.

Banking sector shows signs of improvement but NPLs remain one of the major risks for the stability. As of December 2016 the percentage of NPLs in total loans dropped to 47% compared to July 2016 when it stood at 49,6%. Even though the trend over 2016 shows a small but steady decline in the share of NPLs, the substantially high metric still represents a significant risk to the banking system (see graph 4).

Total assets and private credit dropped significantly in 2016 to 254% and 367% of GDP (310% and 420% in 2015 respectively). Regardless of the drop, the level of domestic private debt is still the highest among its euro peers. Furthermore, the external private debt is even more alarming as it stood at 495% of GDP by 3Q 2016 increasing the external exposure posing an additional threat to debt sustainability.

On the other hand, the banking sector remains well capitalized with capital to assets ratio of 10% and capital adequacy ratio of almost 17% as of December 2016, while ROA was once again negative at -0,34% by end-2016 (see graph 5).

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:

http://raexpert.eu/reports/Press_release_Cyprus_07.04.2017.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.