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Cyprus' Sovereign Rating Upgraded; Outlook Remains Positive

RATING ACTION

Capital Intelligence Ratings (CI Ratings or CI), the international credit rating agency, today announced that it has upgraded the Republic of Cyprus' Long-Term Foreign Currency (LT FC) Issuer Rating to 'BB+' from 'BB' and affirmed its Short-Term Foreign Currency (ST FC) Rating at 'B'. The Outlook for the Long-Term ratings remains Positive.

RATING RATIONALE

The rating upgrade reflects the continued strong performance of the economy, as well as improving public finances and the ongoing recovery of the banking sector. In addition, legislative and structural reforms have helped to increase Cyprus' institutional strength.

The economy continued its robust recovery in 2018, with real output growth of 3.9% (4.2% in 2017) helping to return it to its pre-crisis size in nominal terms. Growth was broad based and underpinned by the services sector (mainly tourism, health and education), as well as ongoing foreign-led construction and real estate projects. As a result of strong growth in domestic demand, import growth also accelerated, but the impact on GDP appears to have been partially offset by rising tourism receipts. The unemployment rate continued to decline, reaching a better than projected 8.8% in 2018, down from 16.1% in 2014. Overall, employment growth has been positive since 2016 and youth unemployment remains on a declining trend.

CI Ratings expects the economy to expand by 3.5% in real terms this year, with the pace gradually moderating to 3% in 2020-21, underpinned by strong projected demand and robust net exports. Downside risks to the outlook remain sizeable, although they appear to be slightly receding as the banking sector is showing solid signs of improvement following the carving out of the non-performing assets of the legacy Cyprus Cooperative Bank (CCB) and the sale of its remaining assets and liabilities to Hellenic Bank. Foreign direct investment is also expected to remain robust in the short to intermediate term in light of initiatives encouraging international private investment in hi-tech, construction, casinos, hotels and marinas, in addition to energy projects linked to the natural gas exploration taking place in Cyprus' exclusive economic zone. However, the strong growth cycle remains subject to downside risks stemming from the concentration of activity in construction and real estate, potential spillovers in the event of a disorderly Brexit, and less favourable economic performance in the Eurozone.

Institutional strength also improved significantly in tandem with broad-based legislative and judicial reforms intended to support banks in reducing their non-performing exposures (NPEs). Despite the government's commitment to post-financial assistance programme reforms, CI notes that there has been a delay in enforcing certain new laws and in implementing politically-sensitive reforms, including reducing the public sector's size and wage bill, improving the functioning of the judiciary, and privatisation. This delay may be partly attributable to the presidential elections which took place early last year.

The general government budget balance – excluding the CCB transaction – strengthened further, posting a surplus of 2.9% of GDP in 2018, compared to a surplus of 1.8% in 2017. (Including the accounting treatment of the revaluation of the CCB asset portfolio that was transferred to the books of the Asset Management Company (AMC), the budget position registered a deficit of 5.1% of GDP in 2018.) The overall budget position is expected to register healthy surpluses averaging 2.9% of GDP in 2019-21, provided fiscal discipline is maintained. Risks to the fiscal outlook persist in view of the limited fiscal space to accommodate unexpected large expenditures, as well as potential spending pressures associated with the new national health system, the ESTIA debt subsidy scheme, and government guarantees on certain former CCB assets.

General government debt increased to 109.3% of GDP in 2018 from 97.5% in 2017 due to the cost of state support for the sale of the CCB. This increase is deemed a one-off and the debt ratio is expected to resume its declining trend, reaching 97.5% in 2019 and 84.6% in 2021 based on current policies and assuming no further support to the banking sector.

Short-term refinancing risks appear manageable in view of the government's sound fiscal management, enabling it to build cash buffers that cover its financing needs for the next nine months. This cash buffer is supported by the government's ability to access international markets at favourable rates. The government has been active in managing its balance sheet to benefit from favourable market conditions.

CI notes that bank balance sheets have improved further with NPEs declining to a still high 32% of gross loans in November 2018. Moreover, the industry has been relatively successful in regaining depositor confidence. Domestic banks have continued to decrease their non-performing loan portfolio through loan restructurings, write-offs, and the partial sale of problematic loan portfolios to specialised credit acquiring companies. Nonetheless, risks stemming from the relatively low provisioning level, which stood at 52% of NPEs, and the private sector's large debt overhang still persist.

OUTLOOK

The Outlook for the ratings is Positive, which indicates a better than even chance that the ratings will be upgraded again in the next 12-24 months. The Positive Outlook reflects CI's current expectation that ongoing reforms and robust economic growth will continue to reduce macroeconomic and fiscal vulnerabilities and strengthen the banking sector, minimising the need for sovereign assistance to the banking system in case of an unexpected crisis.

The ratings could be upgraded in a year's time if the government embarks on further fiscal and structural reforms, which would reduce debt at a quicker pace and weaken the nexus between the sovereign and the banking system, and/or the latter exhibits faster improvement with NPEs dropping to healthier levels and higher provisioning.

Conversely, the Outlook could be revised to Stable in the event the government fails to maintain fiscal discipline, and/or the banking system requires further financial assistance that adversely impacts the government's balance sheet.

CREDIT RATINGS

Foreign Currency		Outlook
LT	ST	
BB+	B	Positive

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The ratings were initiated by CI. However, the rated entity participated in the rating process. The ratings, rating outlook and accompanying analysis are based on public information and information provided by the rated entity. CI considers the quality of information available on the rated entity to be satisfactory for the purposes of assigning and maintaining credit ratings, but does not audit or independently verify information published by national authorities and other official sector institutions. When preparing this report CI had access to one or more of the following: management, accounts and other relevant internal documents of the rated entity.

The ratings and rating outlook have been disclosed to the rated entity and released without amendment following that disclosure. Ratings on the rated entity were first released in December 1997. The ratings were last updated in September 2018.

The principal methodology used to determine the ratings and rating outlook is the Sovereign Rating Methodology. The methodology, the meaning of each rating category, the time horizon of rating outlooks and the definition of default, as well as information on the attributes and limitations of CI's ratings, can be found in the methodology or else at www.ciratings.com. CI's policy on unsolicited ratings, including an explanation of the colour coding of credit rating symbols can be found at the same location. Historical performance data, including default rates, are available from a central repository established by ESMA (CEREP) at http://cerep.esma.europa.eu.

The credit ratings and rating outlook are opinions of CI and not statements of fact. They do not constitute investment or financial advice and should be relied upon by users of ratings to a limited degree.