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Countercyclical Capital Buffer

Background material for decision

March

2019

The publication was prepared by the Economics and Financial Stability Service of the Bank of Lithuania.

Unless otherwise indicated, the cut-off date for data used in the publication is 14 February 2019.

Periods indicated in charts include data for the respective year, quarter, etc.

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DECISION BASIS FOR SETTING THE COUNTERCYCLICAL CAPITAL BUFFER RATE

On 26 March 2018, the Board of the Bank of Lithuania took a decision* to leave the countercyclical capital buffer (CCyB) rate unchanged at 1%, as set in June 2018. It will come into effect on 30 June 2019.**

Such a decision was taken in view of the recent financial and economic trends, as well as core and additional indicators for setting the CCyB rate. The credit and real estate (RE) market analysis points to no significant imbalances in the financial system, yet the financial cycle in Lithuania is on an upswing. In periods of moderate systemic risk, when credit and RE market activity is relatively high, the domestic economy is expanding and corporate financial health is strong, the Bank of Lithuania seeks to ensure that banks accumulate a 1% CCyB.

The portfolio of loans to the private non-financial sector has increased but remains stable. In 2018, its annual growth rate stood at 6.0%, a year-on-year decrease of 0.2 percentage point. The slowdown was led by a contraction in the corporate loan portfolio, reflecting amortisation of individual large-scale loans and the reduced volume of micro-lending. The annual growth rate of the portfolio of loans to households, conversely, has increased and reached 8.7% at the end of 2018. Lending continued to be driven by the improving economic situation in the country as well as more positive business and household expectations. However, after a long period, interest rates started to rise in 2018, while banks began gradually tightening lending conditions. Nonetheless, the growth rate of the portfolio of loans to the private sector should not exceed the projected nominal economic growth in 2019.

In Q4 2018, activity in the housing market remained at historic highs. According to the Centre of Registers, in Q4 2018 4.5% more housing was assigned across Lithuania on a year-on-year basis, while the total number of transactions in 2018 was 1.9% higher compared to the previous year. The annual growth rate of house prices in Lithuania has slightly diminished and stood at 6.6% in Q3 2018. The annual growth rate of house prices in Vilnius has increased by 0.3 percentage point to reach 3.5%, while in the remaining part of the country it slowed down by 1.9 percentage points (to 9.1%).

With no significant imbalances, the level of cyclical systemic risk in the financial system remains average. The 1% CCyB rate set by the Bank of Lithuania is justified in terms of the current state of the domestic financial system. The gap between the credit-to-GDP ratio and its long-term trend remains negative, the loan-to-deposit ratio fluctuates around 100%, the current account balance is positive and house prices are not overestimated in terms of income growth rates and other fundamental factors. Thus it might be stated that the likelihood of a systemic crisis in Lithuania is low.

* Resolution No 03-66 of the Board of the Bank of Lithuania of 26 March 2019 on the application of the countercyclical capital buffer.

** The 0.5% CCyB rate came into effect on 31 December 2018, the 1% CCyB rate will come into effect on 30 June 2019.

DEVELOPMENTS IN CREDIT AND REAL ESTATE MARKET

According to the Bank of Lithuania's assessment, in Q4 2018 lending in Lithuania remained active, yet its growth rate scaled down. This is also evidenced by the credit impulse, which was negative for several consecutive months. In 2018, the portfolio of loans to the private non-financial sector increased by 6.0% (compared to 6.2% in 2017). The slowdown in the loan portfolio in Q4 2018 was primarily led by faster loan repayments by major borrowers – manufacturing and trade enterprises – although this decline was somewhat offset by increased lending to holding companies.¹ The portfolio of loans to non-financial corporations expanded by 3.2% in 2018, its weakest growth performance since the beginning of 2016. Contrary to corporate lending, growth in the portfolio of loans to households has been robust for the last few years, having reached 8.7% at the end of 2018.

Having fluctuated around 8% for the last several years, household lending gained momentum in Q4 2018. Lending to households remains active. Such trends are underpinned by the more favourable macroeconomic environment (i.e. rapidly increasing wages and diminishing unemployment), improving household sentiment and interest rates that remain historically low (although gradually rising). In Q4 2018, the annual growth rate of the housing loan portfolio has accelerated to reach 8.7% in December 2018 (a year-on-year increase of 0.7 percentage point). The net flow of new housing loans followed an upward trajectory as well: in 2018 it amounted to €1.3 billion, an increase of 10.1% compared to 2017. At least for now, such trends go hand in hand with fundamental factors: the ongoing tensions in the labour market underpin the rise in employment rates and robust wage growth (9.5%² over 2018). The improving financial health of households is boosting consumer confidence. For the first time since March 2008, the consumer confidence indicator turned positive in the second half of 2018. At the same time, an increasing share of households acquired durable consumer goods (housing, cars); part of such purchases are usually financed with borrowed funds. On the other hand, the number of factors that may prevent growth in the household loan portfolio has risen as well. According to bank lending surveys, lending conditions are becoming somewhat tighter, while interest rates for new housing loans increased in 2018.

Lending to non-financial corporations slumped in the last quarter of 2018. In 2018, the annual growth rate of the portfolio of loans to non-financial corporations granted by monetary financial institutions (MFIs) amounted to 3.2% (in 2017 – 4.9%), reaching its lowest point in the last three years. Such changes were mainly driven by one-off factors – several large enterprises (e.g. manufacturing and trade enterprises, holding companies) borrowed from banks or repaid previously granted loans. Lending to the smallest enterprises (with up to 10 employees) declined, while the flow of micro-lending (loans for up to €0.25 million) dropped by a third over the year. On the other hand, lending to small and medium-sized enterprises (with 10-249 employees) continued on an upward path and was the main contributor to the overall growth in the portfolio of corporate loans. Despite the anticipated slowdown in Lithuania's export growth³, demand for corporate lending in 2019 should be fuelled by robust investment and increasing flows of EU funds.

It should be noted that demand for corporate lending has declined as some enterprises attracted funds they lacked from abroad. Attracting funds from foreign holding companies or by issuing debt securities abroad is becoming increasingly common. For instance, in 2005-2008 funds attracted from abroad accounted for roughly a fifth of the total flow of financial liabilities of non-financial corporations, whereas in 2016-2018 the share of such funding increased to one-third.

In Q3 2018, the annual growth rate of house prices in Lithuania continued to moderate. However, more recent RE market participant data suggests that the rise in apartment prices in major cities gained momentum at the end of the year. According to the latest data of Statistics Lithuania, in Q3 2018 house prices in the country were up by 6.6% year on year (a quarter-on-quarter decrease of 0.8 percentage

¹ The category of holding companies includes enterprises engaged in professional, scientific and technical activities (according to the statistical classification of economic activities).

² Bank of Lithuania projection for December 2018.

³ The slowdown in export growth in 2019 will be mainly led by the decline in re-exports.

point from 7.4%). The ongoing robust rise in house prices was observed outside the country's capital. In Vilnius, house prices increased by 3.5%, in the remainder of the country – by 9.5%. According to the more recent UAB Ober-Haus data on the apartment price index, at the end of 2018 growth in apartment prices in Lithuania somewhat accelerated, compared to Q3 2018. In December 2018, apartment prices across Lithuania were 3.9% higher on a year-on-year basis (the growth rate in Q3 stood at 3.2%). The most pronounced price increases were recorded in smaller cities: the annual growth rate of apartment prices in Šiauliai and Panevėžys stood at 8.9% and 11.6% respectively. The annual increase in apartment prices in Vilnius, Kaunas and Klaipėda was 2.8%, 4.1% and 3.5% respectively.

Housing market activity in 2018 was the strongest since 2007 (in terms of number of residents – since 2004). According to the Centre of Registers, in 2018, 45.1 thousand housing units were sold across the country – a year-on-year increase of 1.9%. The number of such transactions reached 16.1 per thousand residents (the highest number in 15 years). In Q4 2018, the number of apartment and house transactions in the country reached 11.9 thousand, a year-on-year increase of 4.5%. Regarding housing market activity, there are still significant regional differences: the rise in the number of transactions during the abovementioned period was mainly driven by stronger housing market activity in Vilnius and Kaunas, where it picked up by 9.4% and 9.5% respectively. Over the quarter, housing market activity in Klaipėda and the rest of the country showed a moderate change (an increase of 3.6% and 1.2% respectively). Activity in Vilnius primary apartment market remained relatively high in Q4 2018. According to UAB Eika, in the last three months of 2018, the number of new-build apartments sold and reserved by RE developers grew by a fourth (23.1%) year on year and almost by a tenth (8.3%) compared to the average number per quarter in 2016-2018.

The supply of new-build housing in Lithuania has not changed significantly over the quarter and remained at historic highs. According to the data of Q3 2018, the annual number of apartments built in Lithuania remained almost unchanged on a year-on-year basis (12.4 thousand). During the year, the housing supply has increased the most in Kaunas and Vilnius regions (cities and their districts), while the number of new-build apartments in the rest of the country has decreased by a fifth. The share of private houses built in Lithuania remained higher compared to apartments in multi-apartment buildings, although the number of apartments built during the reporting period grew more rapidly. On the other hand, the number of construction permits issued in 2018 has significantly decreased (-8.0%). Although in Vilnius and Klaipėda regions the number of construction permits issued rose by 7.4% and 4.4% respectively, it has dropped by 41.5% in Kaunas region.

Expectations regarding the rise in prices of new-build housing have strengthened, whereas no significant changes in prices of old-construction apartments are expected to take place in 2019. According to the Bank Lending Survey conducted by the Bank of Lithuania in Q4 2018, the majority of respondents (63%) expected prices of new-build apartments to rise by up to 5% over the next 12 months. With regard to old-construction apartments, the majority of banks (63%) expected them to remain unchanged over the year. Compared to the Bank Lending Survey conducted in Q3 2018, the share of banks anticipating a rise in prices of new-build apartments increased by 19 percentage points.

The negative credit-to-GDP gap slightly reduced in Q3 2018, while most indicators that are used to assess the build-up of financial system imbalances did not signal excess risk. In Q3 2018, the overall annual credit (including non-banking credit) growth stood at 10.2%, while nominal GDP expanded by 7.1%.⁴ However, the quarterly credit growth rate was lower compared to the quarterly GDP growth rate, leading to a 0.6 percentage point decline in the credit-to-GDP ratio in Q3 2018 (to 66.8%). At the same time, the negative gap between the credit-to-GDP ratio and its long-term trend slightly increased and, subject to the method of assessment, fluctuated between -9.6 and -2.8 percentage points at the end of Q3 2018. Other indicators also suggest that there are no significant imbalances in the financial system and that the level of cyclical systemic risk is sustainable. For instance, at the end of Q3 2018, the MFI loan-to-deposit ratio continued to fluctuate at

⁴ Expressed as the last four-quarter moving sum.

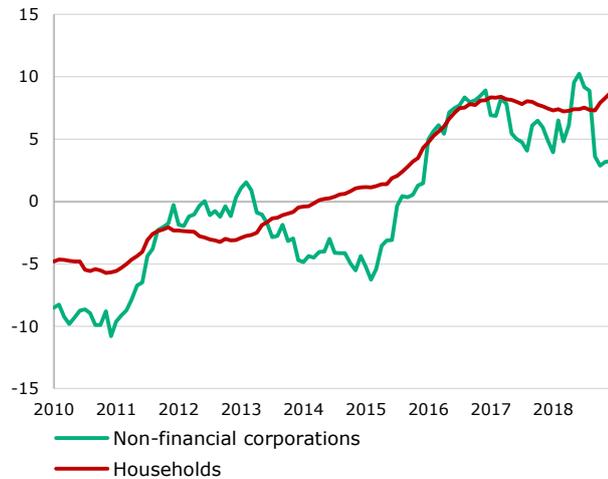
100%, the current account balance improved over the quarter, while the gap between the house price-to-income ratio and its long-term trend remained negative. Given that trends in RE and credit markets in Q3 2018 remained largely unchanged, the CCyB rate was left at 1.0%.

ANNEX 1. CREDIT AND HOUSING MARKET TRENDS

Chart 1. Annual growth of the portfolio of loans to non-financial corporations and households

(January 2010–December 2018)

Percentages

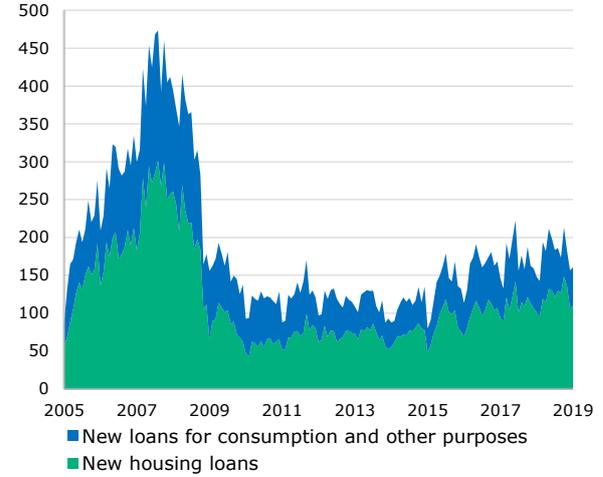


Source: Bank of Lithuania.

Chart 2. Flow of new loans to households

(January 2004–January 2019)

EUR millions

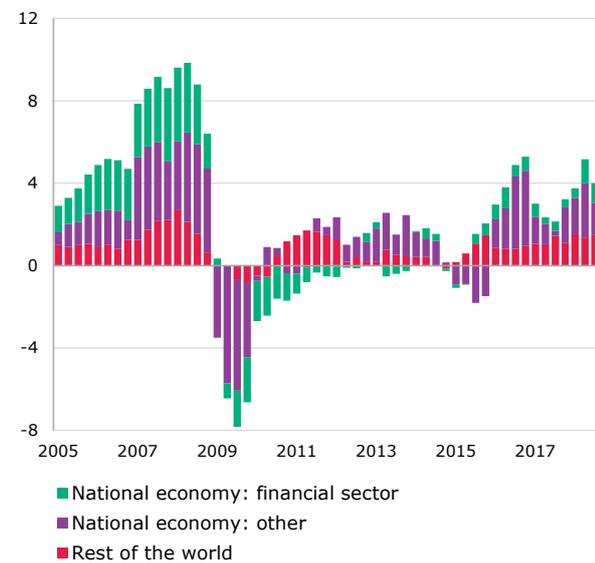


Source: Bank of Lithuania.

Chart 3. Flows of financial liabilities of non-financial corporations (4-quarter moving sum)

(Q1 2005–Q3 2018)

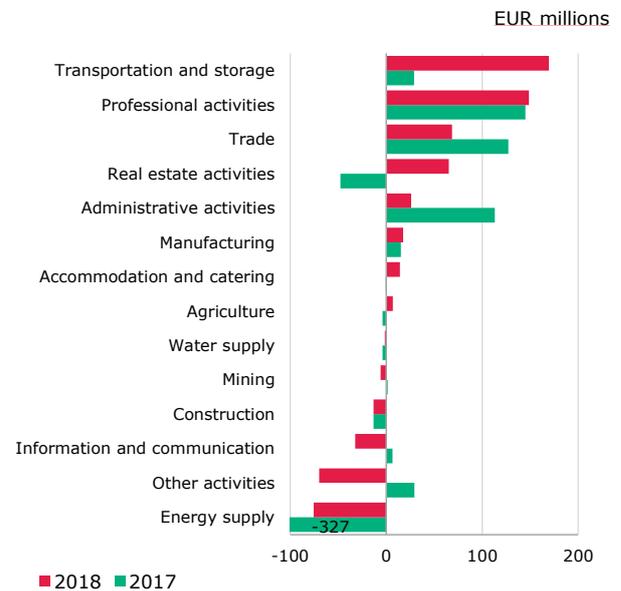
EUR billions



Source: Bank of Lithuania.

Chart 4. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity

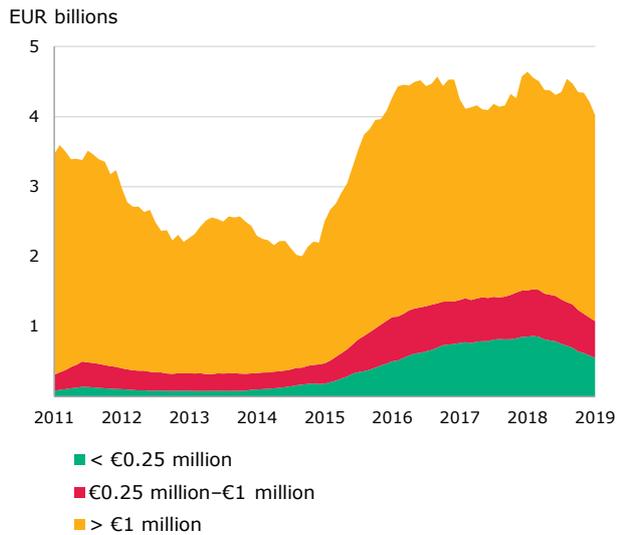
(2017-2018)



Source: Bank of Lithuania.

Chart 5. Flow of new corporate loans by loan size (12-month moving sum)

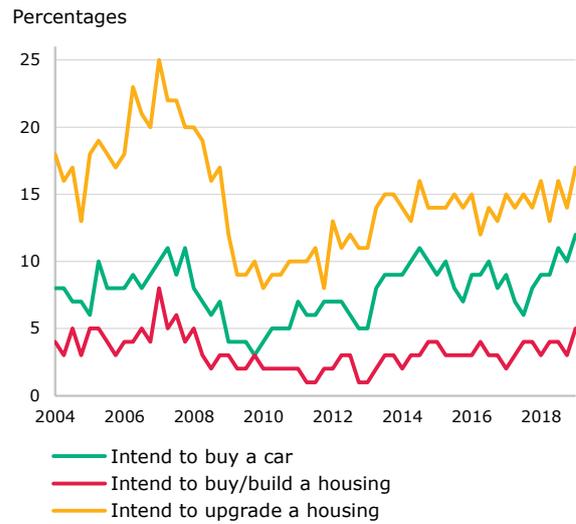
(January 2011–January 2019)



Source: Bank of Lithuania.

Chart 6. Share of consumers intending to take a certain action within the year

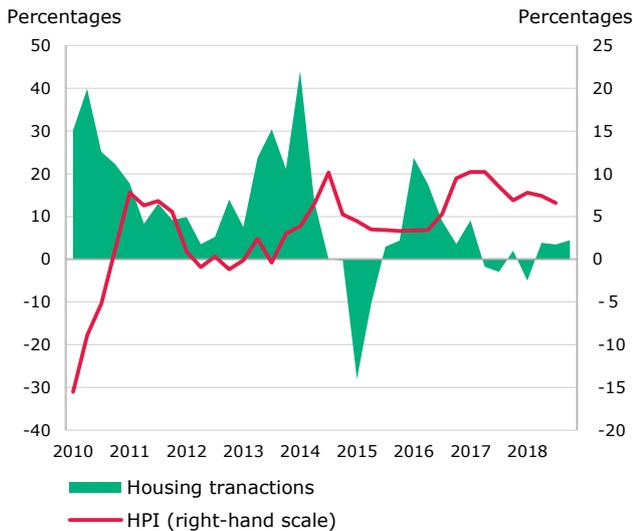
(January 2004–January 2019)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Chart 7. Annual change in the number of housing transactions and the house price index

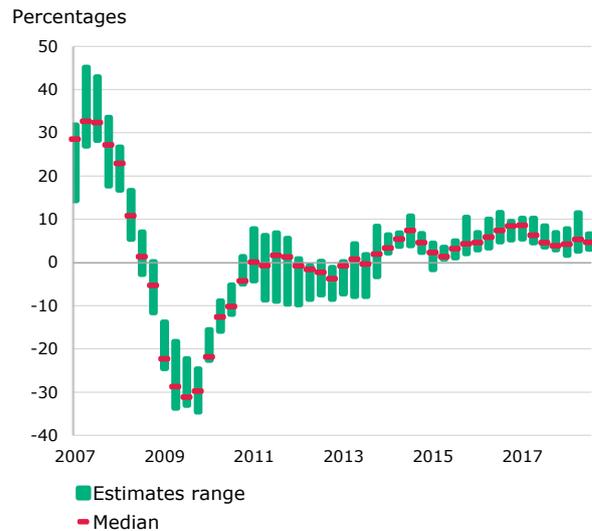
(Q1 2010–Q4 2018)



Sources: Centre of Registers and Statistics Lithuania.

Chart 8. Annual growth in house prices according to different sources

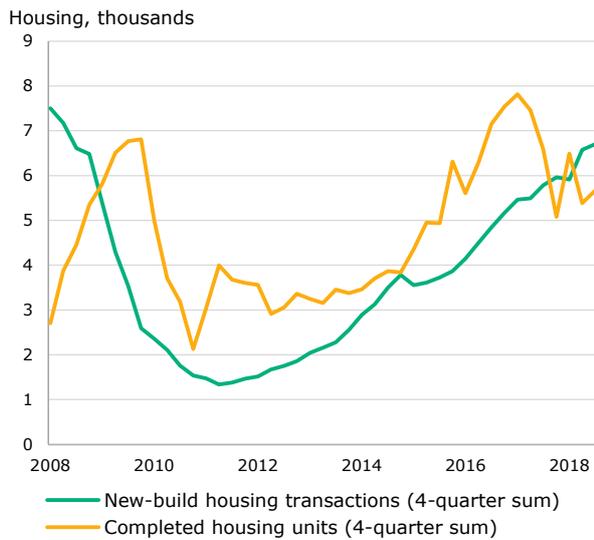
(Q1 2007–Q2 2018)



Sources: Centre of Registers, Statistics Lithuania, UAB Ober-Haus, Aruodas.lt.

Chart 9. Number of new-build housing transactions and completed housing units

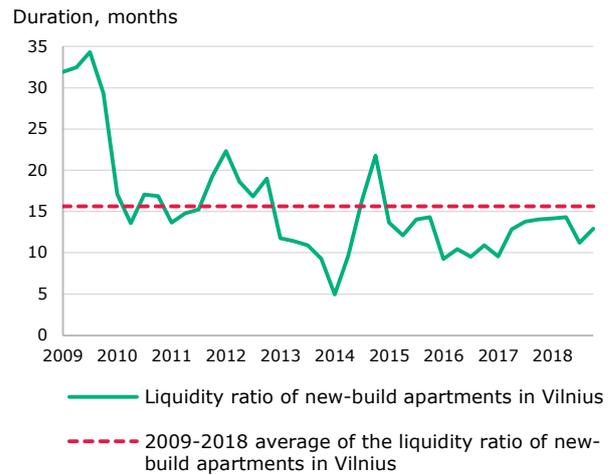
(Q1 2008–Q3 2018)



Sources: Centre of Registers and Statistics Lithuania.

Chart 10. Liquidity within Vilnius new-build apartment market

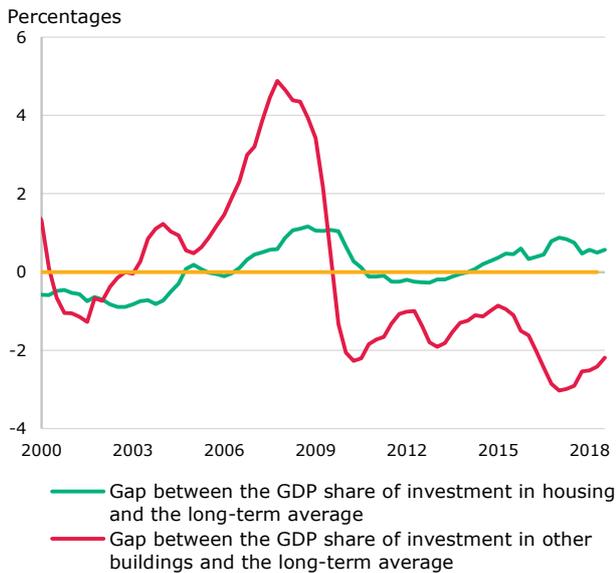
(Q1 2009–Q4 2018)



Sources: UAB Eika and Bank of Lithuania calculations.
Note: The liquidity ratio indicates how much time it would take for developers to sell the apartments offered if demand remained the same and no more apartments were built.

Chart 11. Gap between investment in housing and other buildings (compared to GDP) and the long-term average

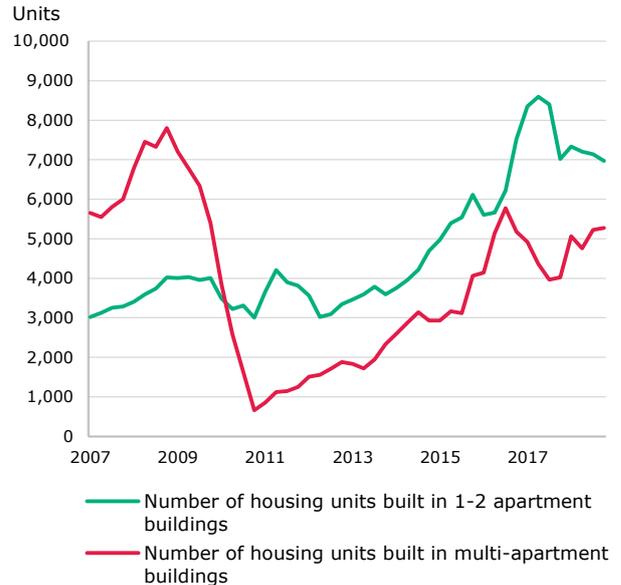
(Q1 2000–Q2 2018)



Source: Statistics Lithuania.

Chart 12. Completed housing units per year (4-quarter moving sum)

(Q1 2001–Q2 2018)

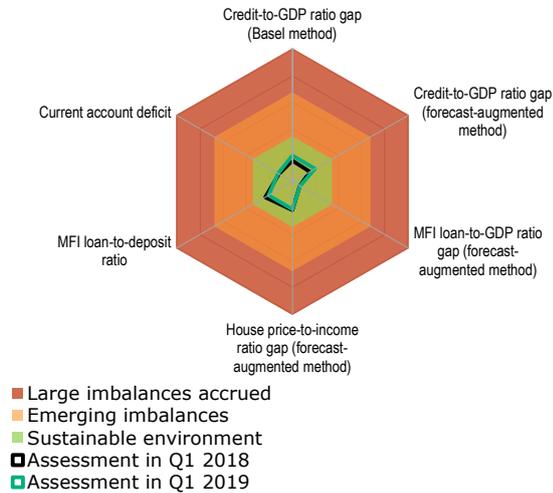


Source: Statistics Lithuania.

ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

Chart A. Evaluation of credit market imbalances based on core and additional indicators

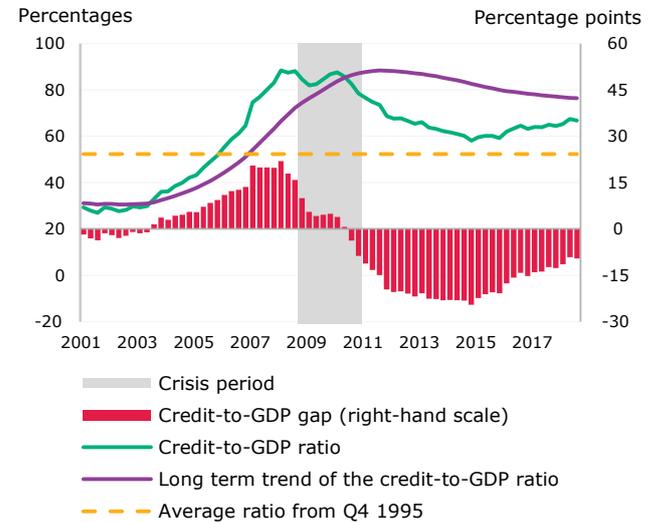
(Q1 2019)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Axes are scaled according to the range of a particular indicator: from its minimal value up to the maximal value.

Chart B. Core indicator I: Credit to the private non-financial sector-to-GDP ratio gap (calculated using the standardised Basel method)

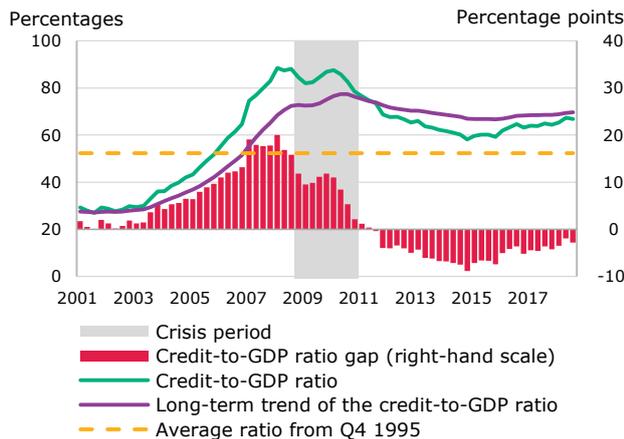
(Q1 2001–Q3 2018)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

Chart C. Core indicator II: Credit to the private non-financial sector-to-GDP ratio gap (calculated using the forecast-augmented method)

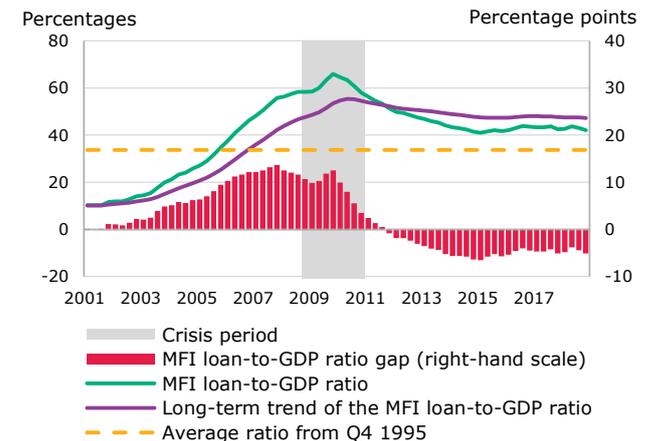
(Q1 2001–Q3 2018)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

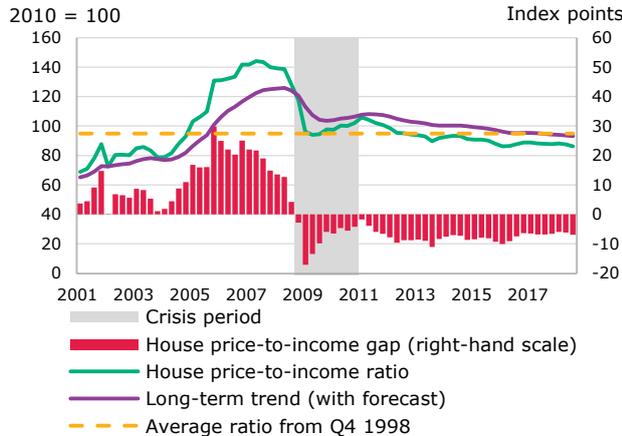
Chart D. Additional indicator I: MFI loan to the private non-financial sector-to-GDP ratio gap (calculated using the forecast-augmented method)

(Q1 2001–Q4 2018)



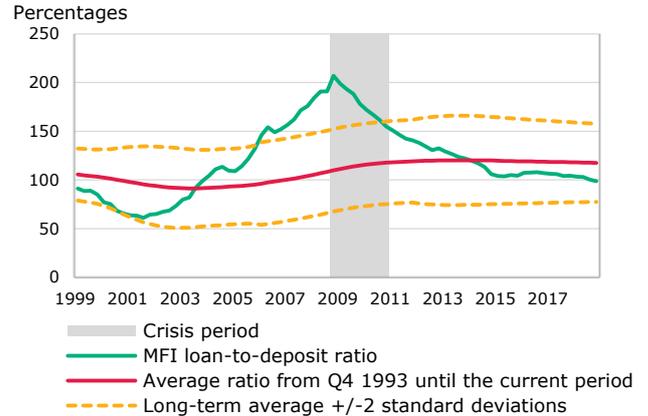
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart E. Additional indicator II: House price-to-income ratio gap
(calculated using the forecast-augmented method)
(Q1 2001–Q3 2018)



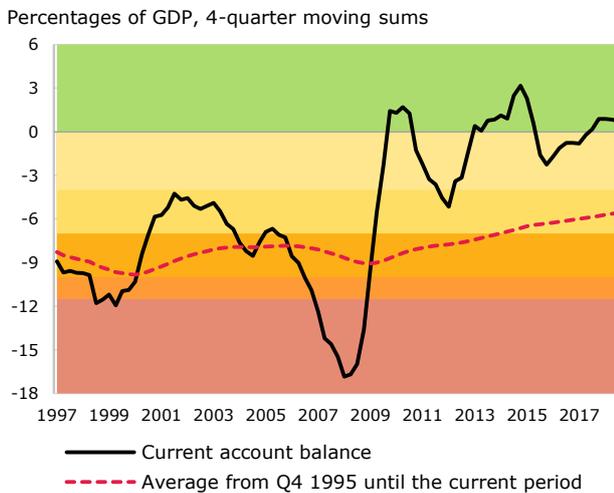
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Notes: 1) income – household wages and salaries; 2) the long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart F. Additional indicator III: Ratio between MFI loans to the private sector and private sector deposits (adjusted for seasonal effects)
(Q1 1999–Q3 2018)



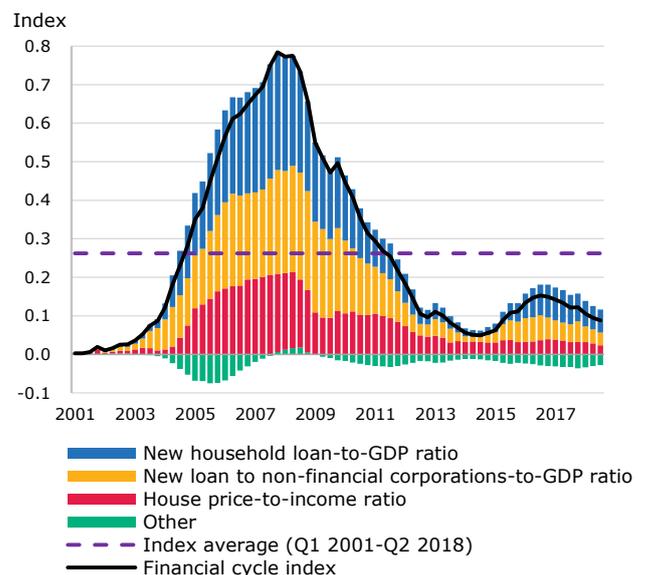
Source: Bank of Lithuania calculations.
Note: The ratio develops in a balanced way if it does not deviate from its long-term average by more than two standard deviations. Standard deviation is computed on the basis of data covering the period of moderate changes in the ratio, excluding data for Q2 2006–Q4 2011.

Chart G. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP
(Q1 1997–Q3 2018)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: different colours indicate different levels of risk which have been set based on Reinhart S. M. and V. R. Reinhart (2008): "Capital flow bonanzas: An encompassing of the past and present", NBER working paper, 14321.

Chart H. Contributions to Lithuania's financial cycle index
(Q1 2001–Q2 2018)



Sources: Statistics Lithuania and Bank of Lithuania calculations.