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Countercyclical Capital Buffer

Background material for decision

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Background material for decision

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DECISION REGARDING THE COUNTERCYCLICAL CAPITAL BUFFER RATE

On 23 December 2020, the Board of the Bank of Lithuania took a decision[1] to leave the countercyclical capital buffer (CCyB) rate unchanged at 0%.

Having set the CCyB rate at 0% on 1 April 2020, it was envisaged that it will not be increased for at least a year, i.e. with the improved economic environment, the higher CCyB rate would come into force on 1 April 2022 at the earliest (normally the change takes effect after a transitional 12-month period). This indicative period will also depend on further economic and financial developments. The latest credit and real estate market trends point to no imbalances in the financial system and show that the financial cycle remains on a downward path. Although the current economic outlook has improved compared to spring, there are still certain negative repercussions from the restrictions imposed during the first wave of COVID-19, while the recently deteriorated epidemiological situation is also increasing the risk of poorer economic development[2]. Having eased the restrictions introduced during to the first wave of the pandemic, economic activity in Lithuania substantially increased. Due to this, the country's economy in the third quarter of 2020 contracted by only 0.1% year-on-year, although the overall annual growth stood at -0.8% over the first three months of the year. However, the worsening epidemiological situation is taking its toll on the current economic environment: the reintroduction of lockdown measures during the second wave of COVID-19 has increased the risk of a further deterioration in economic development as well as led to a rise in the number of enterprises directly or indirectly affected by the imposed restrictions, reduced domestic or foreign demand and a lack of liquidity, which will in turn weigh on the financial health of households. Although the flow of new loans to the private non-financial sector has just started to recover, the growing uncertainty and risks may have a dampening effect on it.

CREDIT AND REAL ESTATE MARKET DEVELOPMENTS

The financial cycle remains on a downward path. The gap between the credit-to-GDP ratio and its long-term trend slightly increased, fluctuating between -11.3 and -4.8 percentage points at the end of the second quarter of 2020 (depending on the method of assessment) (see Charts B and C in Annex 2). On the other hand, the gap between the ratio of MFI[3] loans to the private non-financial sector to GDP and its long-term trend turned less negative, reaching -4.9% at the end of the third quarter of 2020. This was mainly due to a recovery in lending volumes. The loan-to-deposit ratio continued to decrease and amounted to 76%, while the current account balance and the house price-to-income ratio increased.

The portfolio of loans to the private non-financial sector continued to shrink, while more active provision of new loans may slow down again. At the end of the third quarter of 2020, the portfolio of MFI loans to the private non-financial sector further contracted, decreasing by 1.3% year on year (in the previous quarter – by 0.7%). These developments were mainly driven by a significant contraction in the portfolio of loans to non-financial corporations as well as the portfolio of consumer and other loans to households, whereas the annual growth of the housing loan portfolio remained robust. In the third quarter of 2020, the issuance of new loans picked up – the flow of household loans reached its year-on-year level, while that of loans to non-financial corporations was recovering at a slower pace, and has not yet reached the volume observed in the third quarter of 2019. Gradually recovering credit flows may start recording decreases once again on the back of the reintroduced lockdown measures, growing risks and uncertainty.

The portfolio of MFI loans to non-financial corporations continued to shrink at a rapid pace and, although the flow of new loans is slightly recovering, the reintroduction of quarantine may lead to its decline. At the end of the third quarter of 2020, the MFI corporate loan portfolio declined by an annual 10.3% (at the end of the second quarter – 9.2%). This was mainly determined by the contraction in new

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[1] Resolution No 03-198 of the Board of the Bank of Lithuania of 23 December 2020 on the application of the countercyclical capital buffer.

[2] Following the decision of the Government of the Republic of Lithuania, the second nationwide quarantine in the country was declared on 7 November 2020.

[3] Monetary financial institution.

loans: the net quarterly flow of new loans to non-financial corporations was lower by slightly more than one-fifth (-21.8%) year on year (in the previous quarter – -46.5%). In the third quarter of 2020, the flow of new corporate loans up to €1 million (including renegotiations) grew by 6.4% year on year, while that of loans exceeding €1 million decreased by 16.6%. Interest rates on pure new loans to non-financial corporations remained stable – in September 2020, their annual average amounted to 3%, remaining unchanged on a quarterly basis. Although the flow of corporate loans is still subdued, it was partially offset by financial support measures introduced during the COVID-19 crisis (in March–September 2020, the total flow of loans provided by credit institutions to enterprises was roughly €500 million lower than a year ago, whereas the value of the financial support measures[4] amounted to €1.3 billion).

Growth in the portfolio of MFI loans to households has slowed down due to a decline in consumer and other loans, yet the recovering flow of new loans may contract once again due to the imposed restrictions. At the end of the third quarter 2020, the household loan portfolio recorded a year-on-year increase of 6.5%, as its growth decelerated by 0.4 percentage point compared to the previous quarter. The growing total loan portfolio was still supported by housing loans which continued to grow at a rapid pace (reaching 9.2%) as a result of the recovered flow of new loans and loan deferrals (accounting for 3% of the portfolio). Recently, the volume of new housing loans has increased, while the total flows of new loans reached their pre-pandemic level. In the third quarter of 2020, the flow of pure new housing loans was 3.4% higher year on year. On the other hand, the portfolio of consumer and other household loans continued to shrink and was 4.4% lower than a year ago, while the quarterly flow of pure new loans in this segment recovered and in the third quarter of 2020 was 5.2% higher on a year-on-year basis. Interest rates remained stable: in September 2020, the annual average of interest rates on new housing loans stood at 2.4%, remaining unchanged on a quarterly basis, while the annual average of interest rates on new consumer loans fell to 8.6% – a quarter-on-quarter decrease of 0.6 percentage point. Household expectations have also improved: in October, the consumer confidence index once again turned positive, i.e. returned to the previous year's level, thus leading to a higher household propensity to spend more. However, the changing situation in the labour market may dampen these expectations and limit credit access to a certain share of population.

In the third quarter of 2020, bank expectations regarding the potential changes in the value of commercial real estate slightly improved, yet the office vacancy rate continued to grow. Although the majority (62.5%) of commercial banks surveyed by the Bank of Lithuania have indicated that they expect a fall in commercial real estate prices during the upcoming year, the share of those not expecting any changes increased. For comparison, according to the surveys conducted in the first and second quarters of the year, all banks expected a drop in commercial real estate prices. In the second quarter, when prices of real estate funds traded on Baltic stock exchanges suddenly returned to the previous levels, their capitalisation in July–September decreased by 2.2%. However, such a change did not significantly differ from the general change in prices of shares traded on Baltic stock exchanges[5]. Nevertheless, as the supply of offices continued to rise, the office vacancy rate in Vilnius grew for the second consecutive quarter: the share of vacant offices in the Lithuanian capital increased by 1.6 percentage points to reach 4.9% and was the highest in the last two years. While office rent prices remained broadly stable over the respective period, there remains the risk that the economic contraction as well as technological and social developments[6] will lead to a decline in commercial real estate demand and an increase in the office vacancy rate. In this case, rental prices may also fall and give rise to higher liquidity risk for commercial real estate managers.

In the third quarter of the year, housing market activity fully recovered after the pandemic-induced shock. According to the Centre of Registers, house sales during the reporting period were 0.8% higher than a year ago, when real estate market activity was historically high. The latest data

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[4] The total envelope of all measures, subsidies for micro-enterprises, tax loans and tax arrears directly implemented by INVEGA by 5 November 2020.

[5] In the third quarter of 2020, OMX Baltic benchmark stock price index declined by 1.3%.

[6] The growing e-commerce and distance work trends.

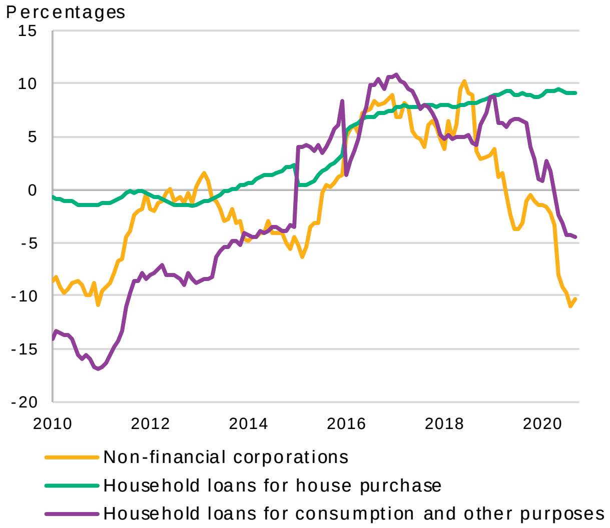
shows that housing market activity in October grew at an even faster rate: on a year-on-year basis, the number of housing transactions in Lithuania increased by a tenth (9.7%). In the respective period, activity levels in the primary apartment market also significantly increased and exceeded the 2018–2019 average: in September and October, the number of new apartments sold in Vilnius was 35.3% and 66.2% higher respectively, compared to the average for the last two years. With a significant rise in activity levels in the primary market, the number of unsold new-build apartments in Vilnius dropped by one-sixth (16.3%).

Relative housing market indicators point to no inflation in Lithuania's house prices, while their potential decline will be halted by sufficient liquidity buffers accumulated by real estate developers. However, rapidly growing housing market activity may induce the risk of house price inflation over the medium term. The COVID-19 pandemic has so far had only a short-term impact on the Lithuanian housing market – after a sharp downturn observed in the first and second quarters of 2020, housing market activity in Lithuania rapidly bounced back and reached its historically high levels. Should the second wave of COVID-19 persist, it is likely to lead to a significant fall in housing market activity as well as a drop in house prices. However, their potential decline might be less pronounced due to the fact that house price levels and inflation have been in line with demographic, macroeconomic and household income developments since the 2008–2009 financial crisis, and are not the result of excessive lending. Moreover, short-term assets of real estate developers exceeded their current liabilities by more than 1.5 times, while their equity was higher than the total amount of liabilities. The sustainable financial health of real estate developers will allow many of them to avoid forced property sales to meet short-term liabilities, and will reduce the risk and scale of a sudden drop in house prices. On the other hand, further robust growth in the housing market may increase the risk of house price inflation over the medium term, especially in case if households have unreasonable expectations regarding their growth and investor activity tends to increase.

ANNEX 1. CREDIT AND HOUSING MARKET TRENDS

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

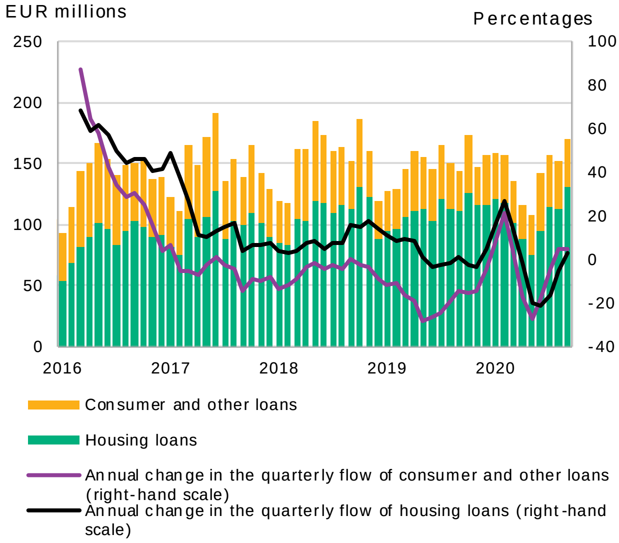
(January 2010–September 2020)



Source: Bank of Lithuania.

Chart 2. Flow of pure new MFI loans to households

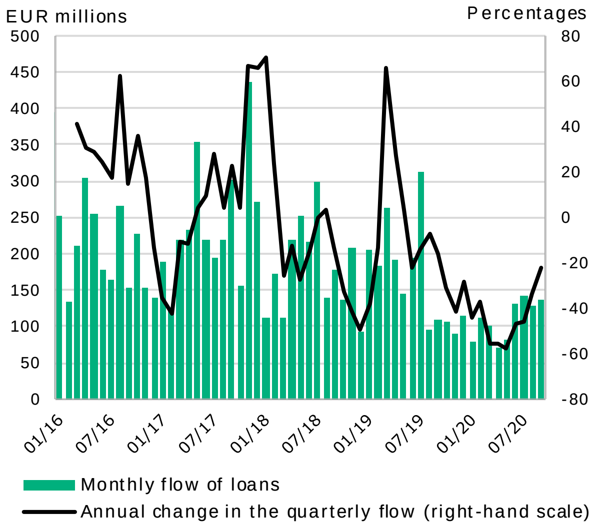
(January 2016–September 2020)



Source: Bank of Lithuania.

Chart 3. Flow of pure new MFI loans to non-financial corporations

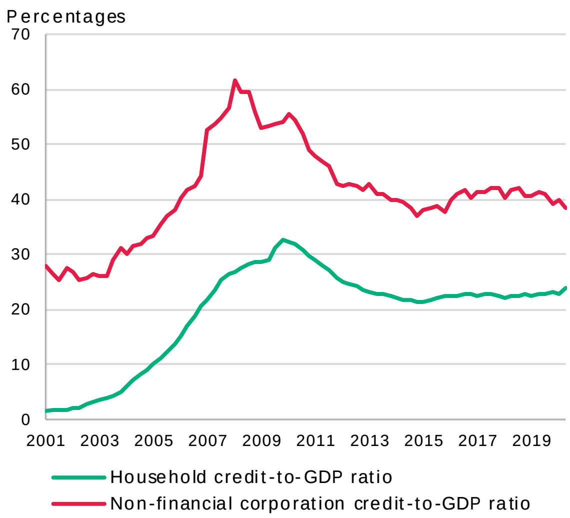
(January 2016–September 2020)



Source: Bank of Lithuania.

Chart 4. Credit-to-GDP ratio of non-financial corporations and households

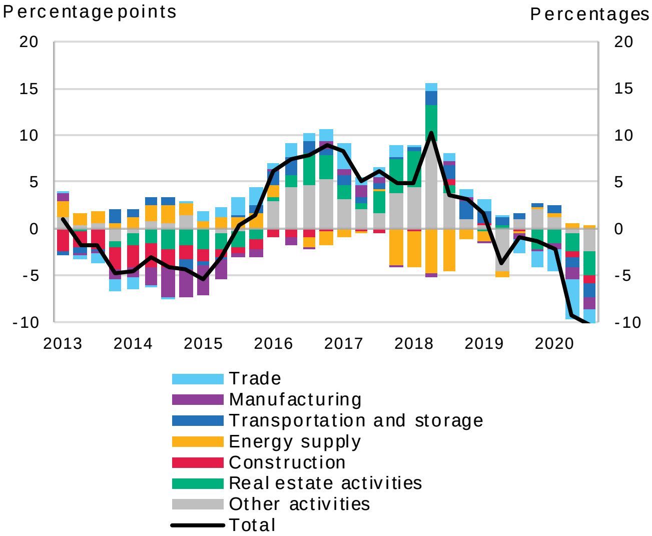
(Q1 2001–Q2 2020)



Source: Bank of Lithuania.

Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity

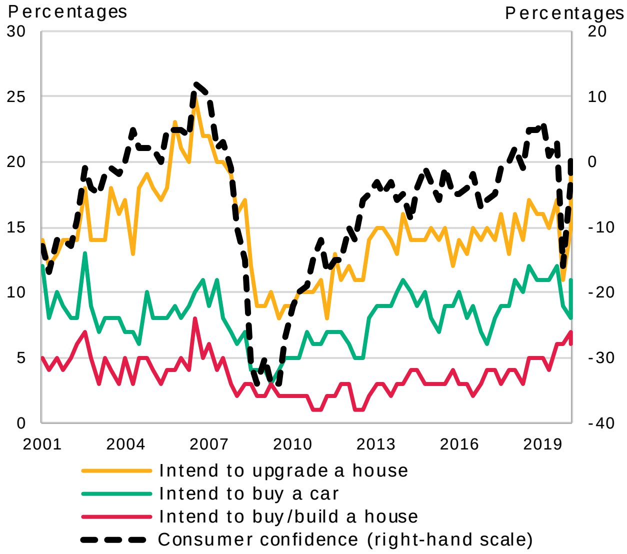
(Q1 2013–Q3 2020)



Source: Bank of Lithuania calculations.

Chart 6. Consumer survey results

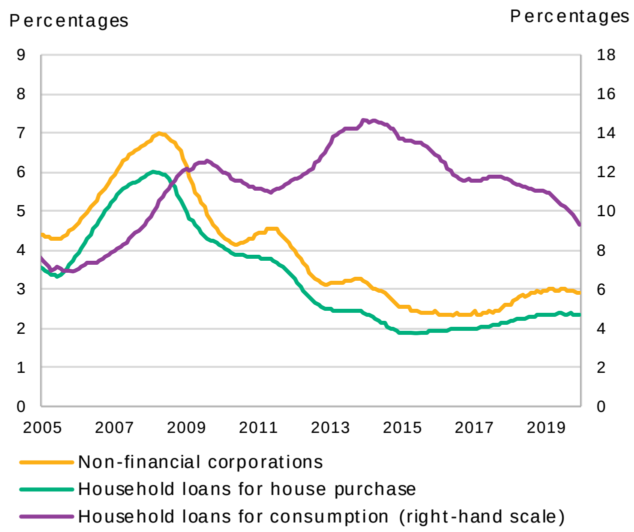
(July 2001–October 2020)



Sources: Statistics Lithuania and Bank of Lithuania.

Chart 7. Average weighted interest rates on new loans to non-financial corporations and households

(October 2005–September 2020)

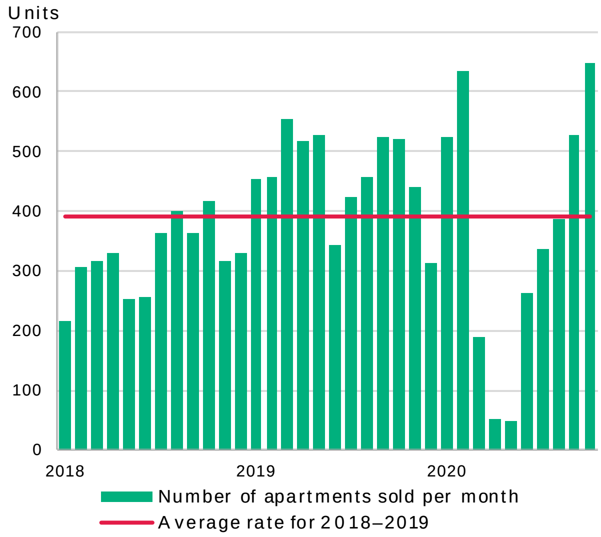


Source: Bank of Lithuania.

Note: 12-month moving average.

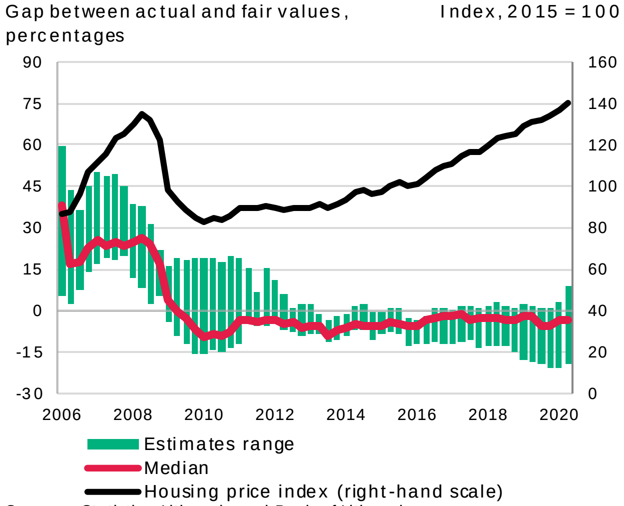
Chart 8. Number of new apartments sold in Vilnius primary market

(January 2018–October 2020)



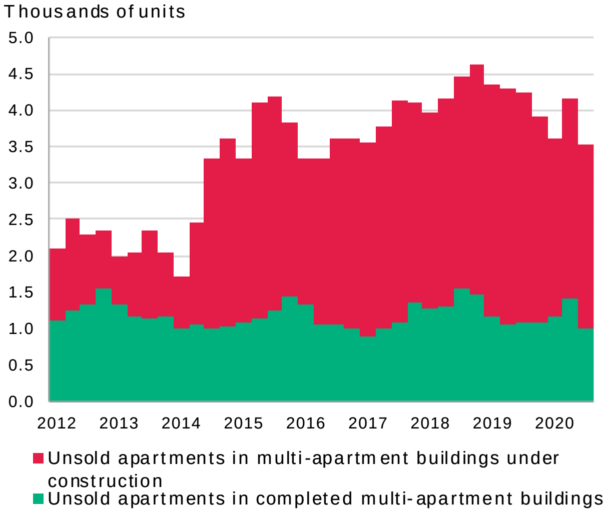
Source: Inreal.

Chart 9. Gap between actual house prices and their fundamental values
(Q1 2006–Q2 2020)



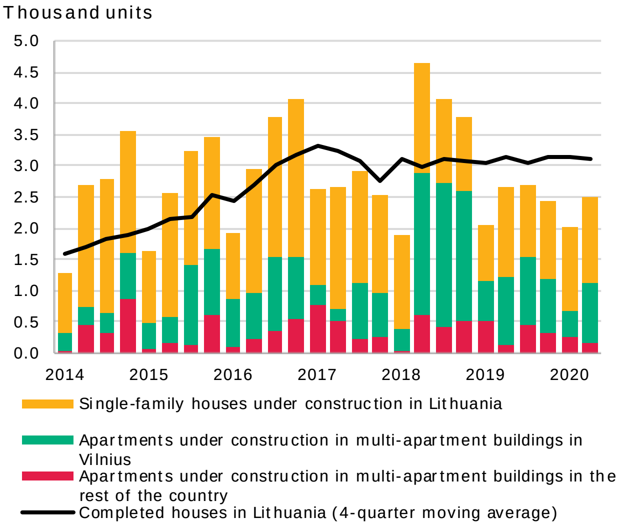
Sources: Statistics Lithuania and Bank of Lithuania.
Note: Calculated based on the house price-to-rent ratio, house price-to-income ratio, an econometric model and the HP filter.

Chart 10. Number of unsold apartments in under-construction and completed multi-apartment buildings in Vilnius
(Q1 2012–Q3 2020)



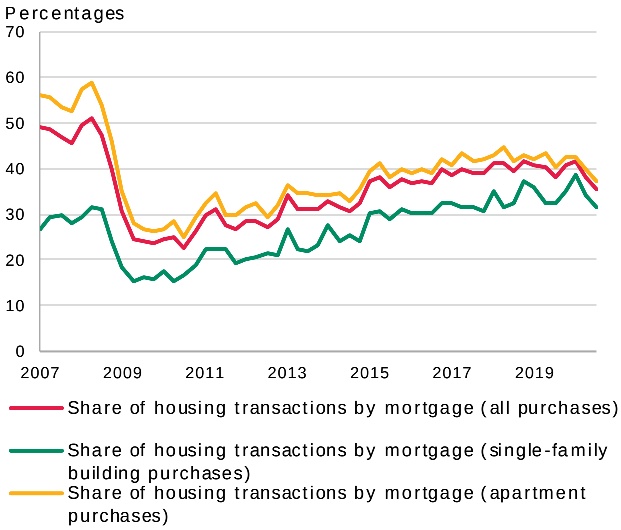
Sources: OBER-HAUS and EIKA.

Chart 11. Number of under-construction and completed houses in Lithuania
(Q1 2014–Q2 2020)



Source: Statistics Lithuania.

Chart 12. Share of housing transactions by mortgage
(Q1 2007–Q3 2020)

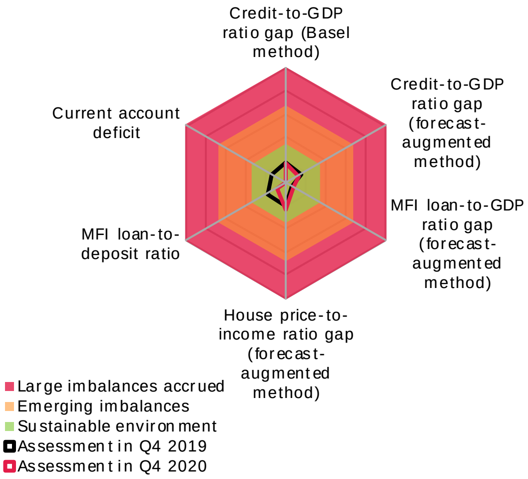


Source: Centre of Registers.

ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

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

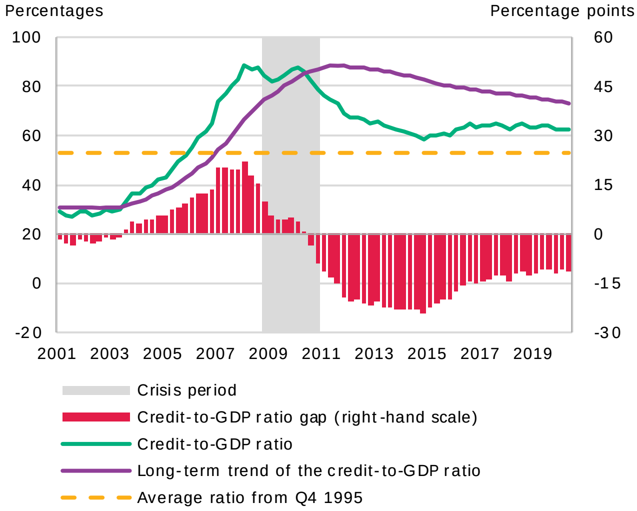
(Q4 2020)



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)

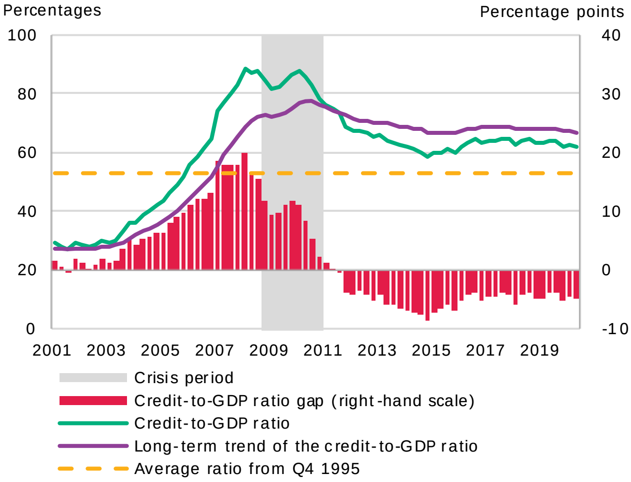
(Q1 2001–Q2 2020)



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 (based on the forecast-augmented method)

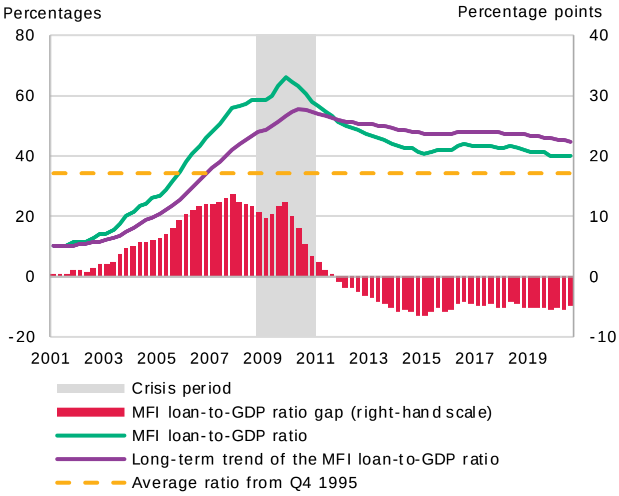
(Q1 2001–Q2 2020)



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)

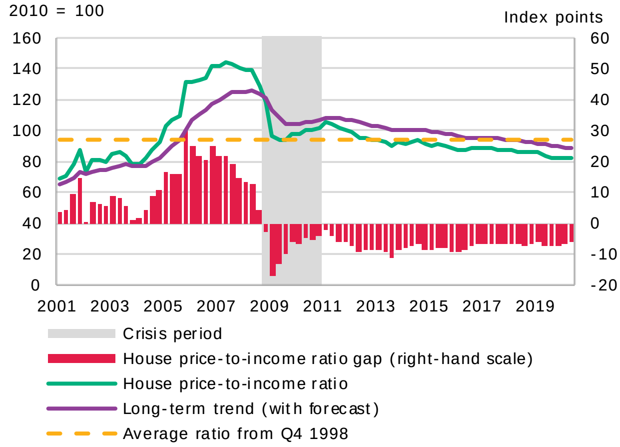
(Q1 2001–Q3 2020)



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)

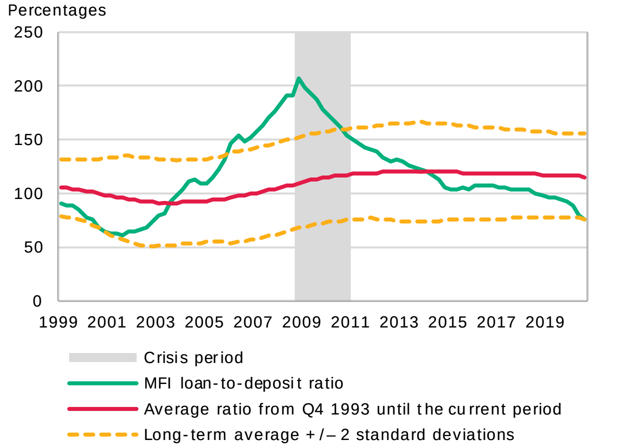
(Q1 2001–Q2 2020)



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)

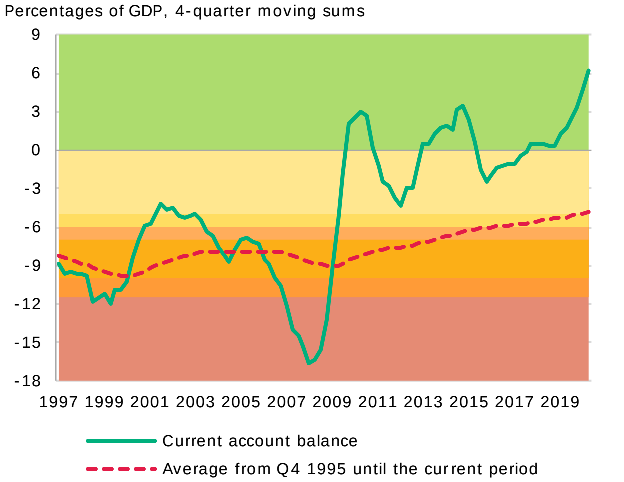
(Q1 1999–Q3 2020)



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

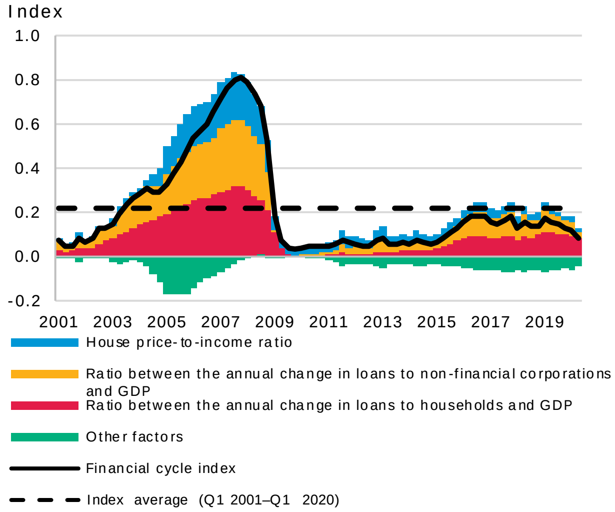
(Q1 1997–Q2 2020)



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 2020)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Since 2020, the financial cycle index has been calculated following a broader definition of credit (covering all credits granted to non-financial corporations and households regardless of the credit provider).