



LIETUVOS BANKAS
EUROSISTEMA

Countercyclical Capital Buffer

Background material for decision

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DECISION REGARDING THE COUNTERCYCLICAL CAPITAL BUFFER RATE

On 28 September 2021, the Board of the Bank of Lithuania took a decision¹ to leave the countercyclical capital buffer (CCyB) rate unchanged at 0%.

The decision to leave the CCyB rate unchanged was taken after assessing the latest trends in the credits and real estate markets which show that, although the housing prices are growing at a more rapid pace and the real estate and housing loan market activity is high, lending to non-financial corporations remains subdued, there are currently no disbalances in the financial system and the financial cycle remains on a downward path, however, signs of recovery gradually appear. The economy is increasingly recovering and corporate and household expectations are rising due to the easing and lifting of containment measures as of 1 July. It is observed that new loans are granted more actively, contributing to the growth of the portfolio of monetary financial institution (MFI) loans to the private non-financial sector, which shrank after the first quarantine. On the other hand, the portfolio of loans to non-financial corporations continues to decrease, and the recent worsening epidemiological situation as well as the introduction of new restrictions that is under consideration are posing new challenges. The further economic development will substantially depend on the success in addressing them. The CCyB rate, which remains unchanged at 0%, will help credit institutions withstand potential losses incurred as a result of the negative impact of challenges of the pandemic on the financial situation of enterprises and households as well as plan future credit-granting activities.

CREDIT AND REAL ESTATE MARKET DEVELOPMENTS

The financial cycle remains on a downward path. Although the gap between the credit-to-GDP ratio and its long-term trend remained negative at the end of Q1 2021, it narrowed, fluctuating between -7.8 and -2.7 percentage points, depending on the assessment method (in the previous quarter it fluctuated between -10.1 and -4.4 percentage points). The narrowing of the gap was mainly determined by the increased corporate credit-to-GDP ratio due to a rise in credit obligations of corporations during the quarter, while the household credit-to-GDP ratio and its gap did not change significantly over the quarter. The gap between the MFI loans to the private non-financial sector and the GDP ratio remained stable, standing at -4.9% at the end of Q2 2021. With the increase in deposits, the decreasing loan-to-deposit ratio, which reached 68% (in the previous quarter it amounted to 68.9%), as well as a positive current account balance, which reduced to 7.5% GDP at the end of Q1 2021 (in the previous quarter it amounted to 8.3%), are sustainable. On the other hand, the house price-to-income ratio slightly worsened: as a result of a rise in real estate prices, it increased up to 86.3% (in the previous quarter it amounted to 84.4%), however remained balanced. The financial cycle index slightly increased, remaining still on a downward path.

In Q2, the flow of new MFI loans to non-financial corporations increased, while their portfolio started contracting at a significantly slower pace. In June 2021, the MFI corporate loan portfolio declined by an annual 3.7% (in the previous quarter it was 11.2% lower year-on-year). The loan portfolios of the majority of economic segments stopped shrinking or continued shrinking at a slower pace. The trade (-1.6 percentage point) and professional, scientific and technical (-1.2 percentage point) activity portfolios were the main contributors to the decrease of the total portfolio, meanwhile the real estate activity portfolio had the largest positive impact on the growth rate of the total portfolio ($+0.9$ percentage point). Although the total portfolio remained smaller than the previous year, the provision of new loans accelerated: the quarterly flow of pure new loans to non-financial corporations was 10% larger compared to the previous quarter and 22.9% larger than the average quarterly flow before the pandemic, i.e. in 2019. Interest rates on pure new loans to non-financial corporations decreased slightly, with their annual average standing at 2.9% in June 2021 (3.0% at the end of previous quarter). Although total credit obligations of non-financial corporations decreased by 1.1% in a year, mostly due to a contraction of MFI loans, the corporate funding through other alternative sources (loans from other corporations and debt securities) intensified. On a quarterly basis, corporate

¹ Resolution No 03-142 of the Board of the Bank of Lithuania of 28 September 2021 on the application of the countercyclical capital buffer.

indebtedness somewhat increased due to a 6.4% rise in credit obligations which was largely influenced by a 23.8% growth in loans from other non-financial corporations.

The portfolio of MFI loans to households grew at an even more rapid pace, mostly driven by active provision of housing loans. In June 2021, the household loan portfolio recorded a year-on-year increase of 8.2%, as its growth accelerated by 1.6 percentage point compared to the previous quarter. The growth of the total loan portfolio remained supported by housing loans which showed an even more rapid growth and stood at 10.6% (increase of 1.2 percentage point on a quarterly basis) as a result of the increased flow of new loans. In Q2 2021, the flow of pure new housing loans was almost 20% larger than during the previous quarter and 60% bigger than the average quarterly flow in 2019. The average of the debt service-to-income (DSTI) and loan-to-value (LTV) ratios of new housing loans have not significantly changed, fluctuating at around 28% and 77% respectively. The portfolio of consumer and other loans to households continued to shrink at a slower pace. In June 2021, it declined by 2.3% year-on-year (in the previous quarter it was 5.4% lower on an annual basis). Interest rates remained stable and unchanged on a quarterly basis: in June 2021, the annual average of interest rates on new housing loans stood at 2.3%, while the annual average of interest rates on new consumer loans reached 8.2%. Consumer expectations heightened: in July, the consumer confidence improved and returned to pre-pandemic level.

In Q2 2021, activity of the housing market was especially high, it has been affected by fundamental factors, such as rising household income, savings and the recovering economy; however the persistent high activity can lead to disbalances. According to the Centre of Registers, in Q2 2021 there was a 79.9% increase in the number of housing sales compared to the corresponding period of 2020, when the first lockdown was introduced and the market was stalled due to the imposed restrictions. Housing sales also increased by 31.4% compared to Q1 2021. The latest data shows that the housing market was less active in June to July 2021 (the number of housing sales in June dropped by 6.5% compared to May and the sales in July fell by 4.5% compared to June), however the number of sales still remains high in comparison to the data of the previous year. The share of housing transactions with mortgage did not change significantly over the year and in Q2 2021 accounted for 42.2% of all housing transactions (a year-on-year decrease of 0.8 percentage point) and 58.2% of the housing value (a year-on-year decrease of 0.9 percentage point). Activity in Vilnius primary apartment market in Q2 2021 was high, yet slightly lower than during the previous quarter (3.3% less apartments reserved), however the number of reservations in July went up (an increase of 40.7% in the number of reserved apartments compared to June, due to significantly lower number of reserved apartments in June). The increase in household income (the average net wage in Q2 2021 in Lithuania was 11.8% higher year-on-year²) and growing deposits with banks as well as optimistic household expectations of housing market prospects contributes to the activity of the housing market. If the high activity in the housing market persists, the market can detach from the overall economic development and disbalances could form.

Relative indicators suggest that housing prices in Lithuania remain at a sustainable level, yet if the observed acceleration in price growth persists, it could lead to the formation of disbalances in the real estate market. According to Statistics Lithuania, the annual growth of housing prices in Q1 2021 accelerated to 12% (an increase of 5.7 percentage points year-on-year and an increase of 2.6 percentage points compared to Q4 2020). According to the repeat sales house price index of the Bank of Lithuania, the prices continued to accelerate in July 2021, with the growth pace of 14.5% (an increase of 1.9 percentage point compared to June 2021). According to the bank lending survey of Q2 2021, all surveyed banks expected a growth in new-construction housing prices in the upcoming years, while 8 of 9 banks expected a growth in old-construction housing prices. Two respondents believed that the growth would be especially rapid and would exceed 10%. Although the current housing prices are not too overvalued, with the current high activity of the housing market, credit flows and growth in housing prices, the gap between housing prices and their fundamental values is expected to further deepen. However, housing price levels and their growth have been in line with household income, demographic

² Based on the data of 27 August 2021.

and macroeconomic developments since the 2008–2009 financial crisis and are not the result of excessive lending.

In Q2 2021, bank expectations regarding potential changes in the value of commercial real estate improved, and the office vacancy rate remained rather stable. Only one of the commercial banks surveyed by the Bank of Lithuania in Q2 2021 indicated that they expected a drop in commercial real estate prices (half of the banks surveyed expected a fall in prices in Q1), while slightly more than half of the respondents expected an increase in prices. At the beginning of 2021, prices of real estate funds traded on the Baltic stock exchanges started to rise and in early August reached the highest level since 2012. This reflects positive investor expectations regarding the prospects of commercial real estate. In Q2 2021, the situation in the office segment remained quite stable: the office vacancy rate in Vilnius saw an increase of 0.1 percentage point, reaching 7.8%³, while rental prices remained broadly unchanged over the period under review. Looking ahead, however, there still remains a risk that commercial real estate demand will decrease and the office vacancy rate will increase due to technological and social developments (with growing e-commerce and remote work trends).

³ According to Colliers data.

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–June 2021)

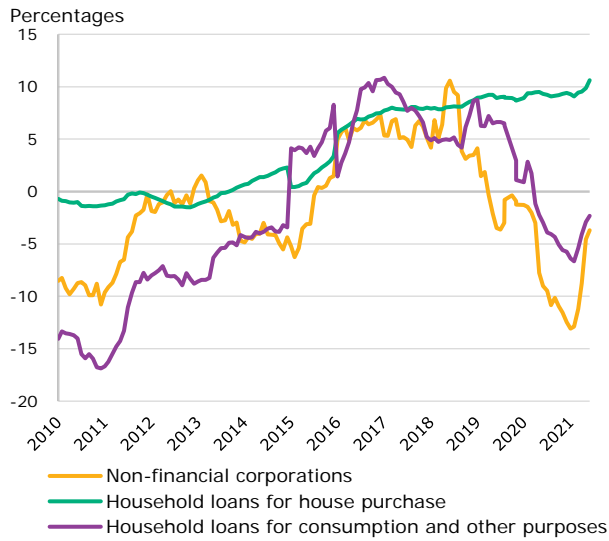


Chart 2. Monthly flow of pure new MFI loans to households (January 2016–June 2021)

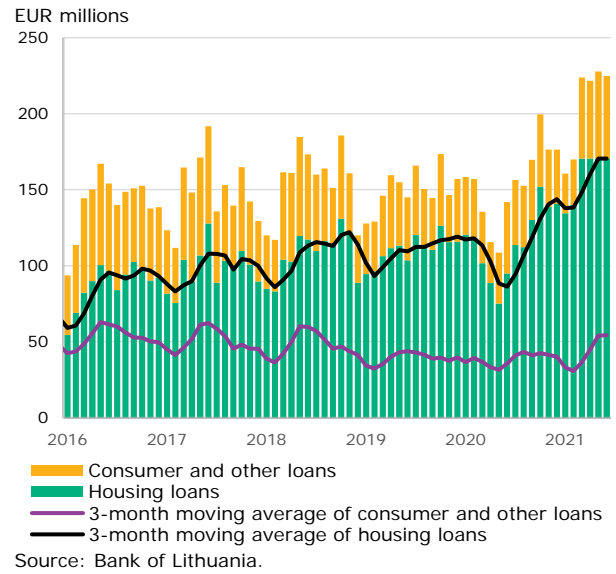


Chart 3. Monthly flow of pure new MFI loans to non-financial corporations (January 2016–June 2021)

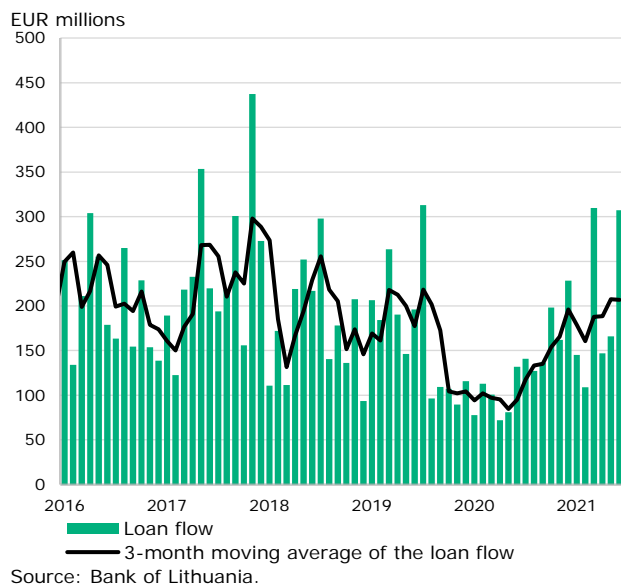


Chart 4. Credit-to-GDP ratio of non-financial corporations and households (Q1 2001–Q1 2021)

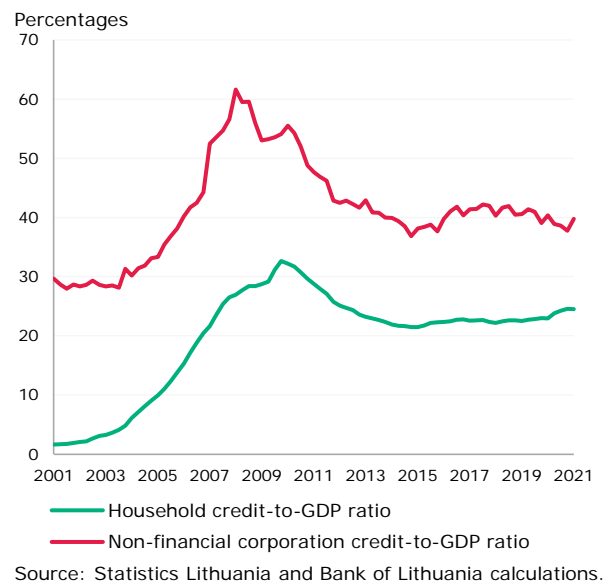
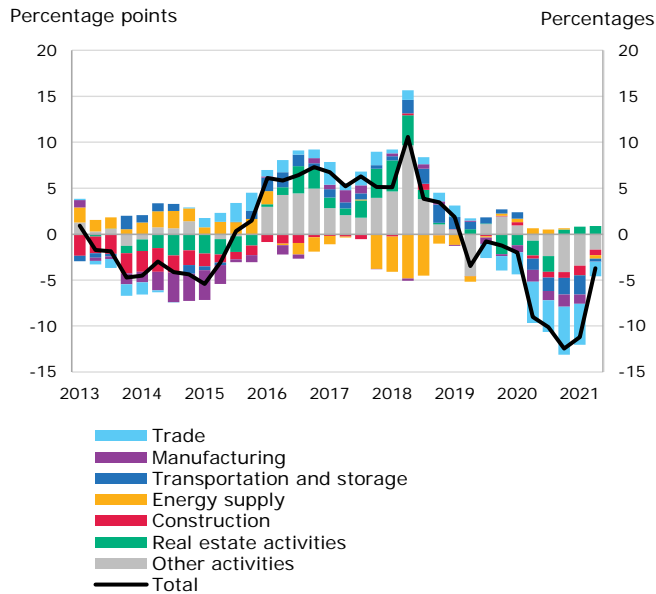
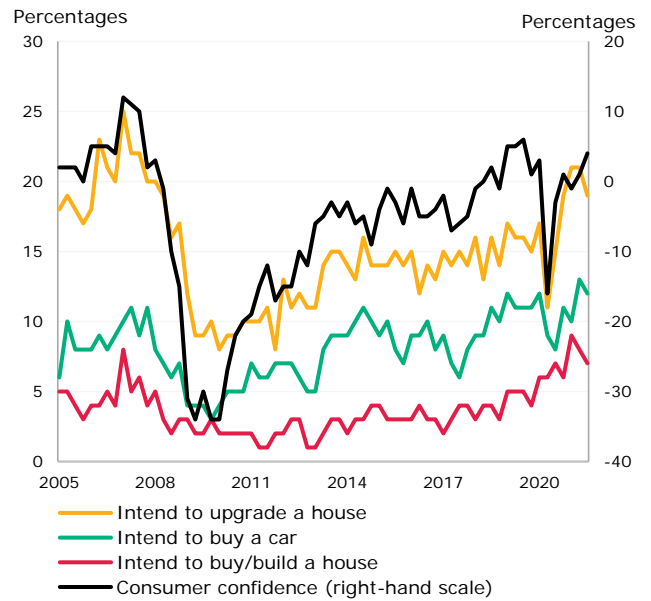


Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity (Q1 2013–Q2 2021)



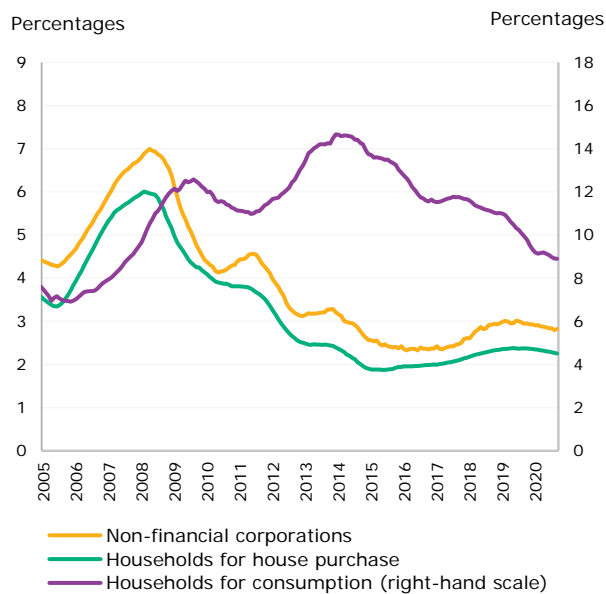
Source: Bank of Lithuania calculations.

Chart 6. Consumer survey results (July 2001–July 2021)



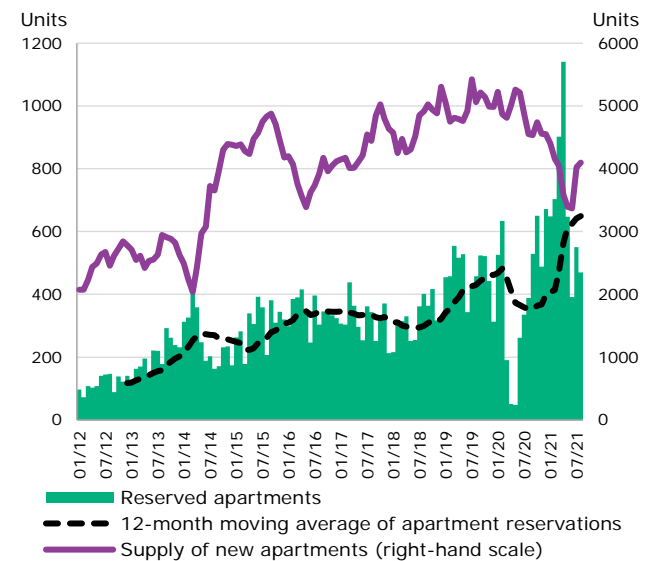
Sources: Statistics Lithuania and Bank of Lithuania calculations.

Chart 7. Average weighted interest rates on new loans to non-financial corporations and households (October 2005–June 2021)



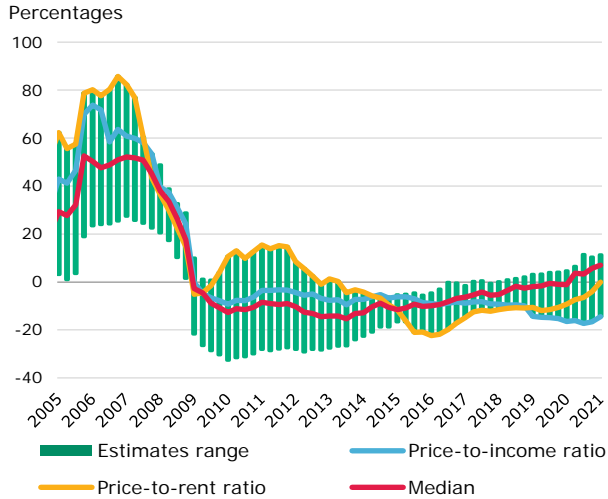
Source: Bank of Lithuania.

Chart 8. Number of new apartments reserved in Vilnius primary market and supply of apartments (January 2010–July 2021)



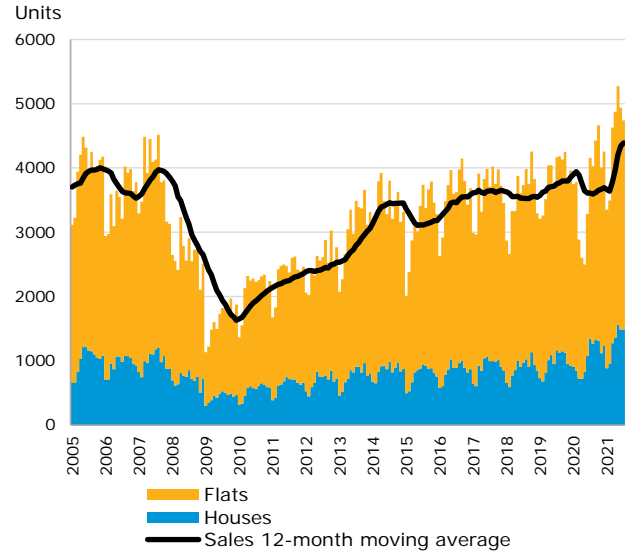
Source: Inreal.

Chart 9. Gap between actual house prices and their fundamental values (Q1 2006–Q1 2021)



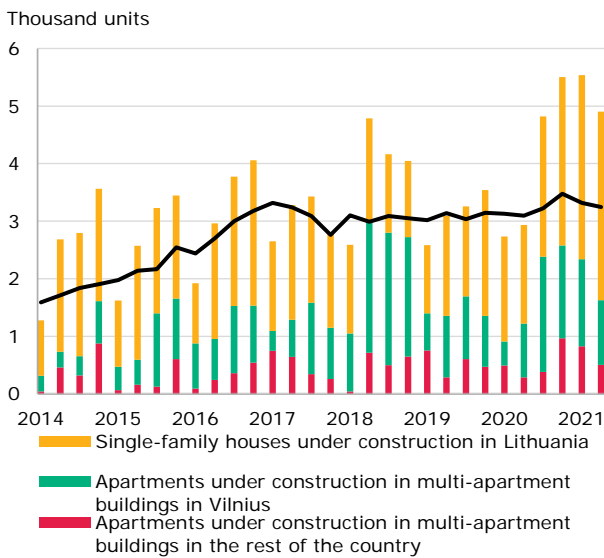
Sources: Statistics Lithuania and Bank of Lithuania calculations. Note: Calculated based on the house price-to-rent ratio, house price-to-income ratio, econometric models and the HP filter.

Chart 10. Apartments sold in a month in Lithuania (January 2005–July 2021)



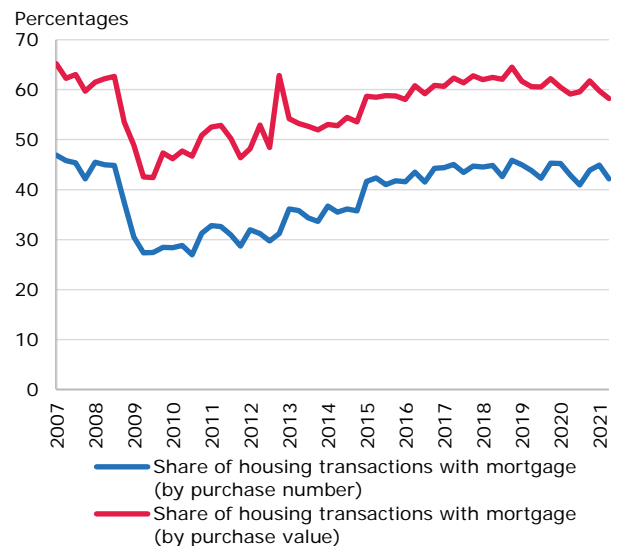
Source: Centre of Registers.

Chart 11. Number of under-construction and completed houses in Lithuania (Q1 2014–Q2 2021)



Source: Statistics Lithuania.

Chart 12. Share of housing transactions with mortgage against all purchases (Q1 2007–Q2 2021)

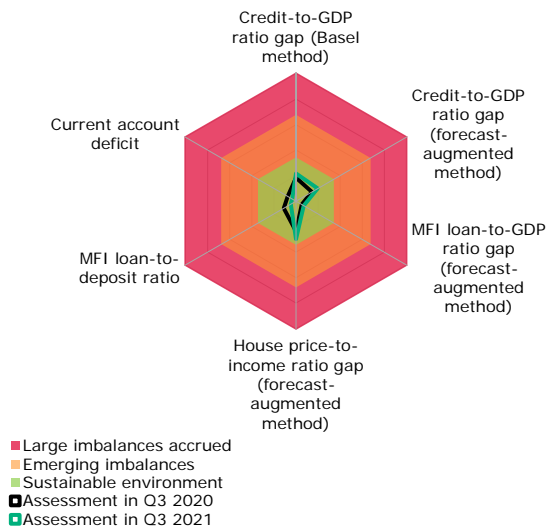


Source: Centre of Registers.

ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

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

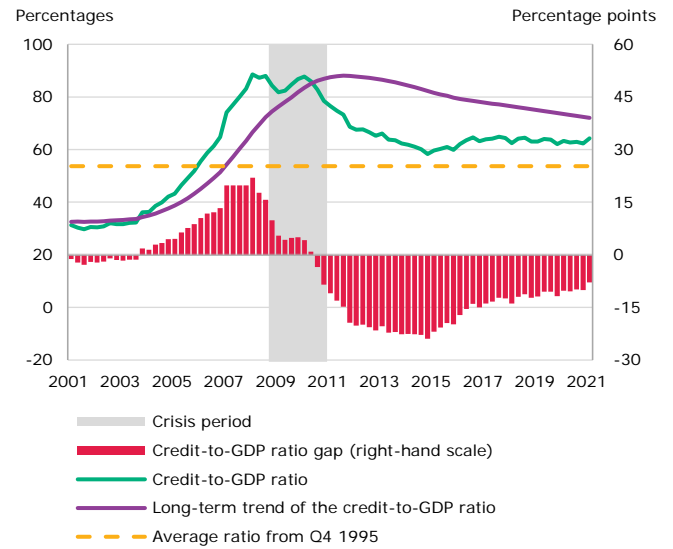
(Q3 2021)



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.

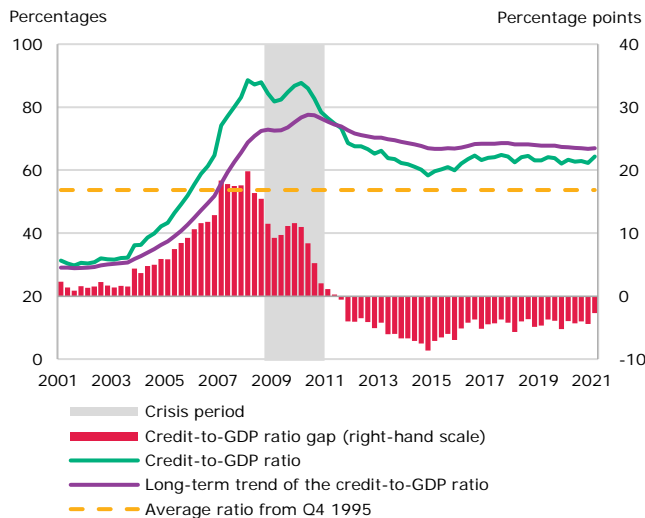
Chart B. Core indicator I: Credit to the private non-financial sector-to-GDP ratio gap (based on the standardised Basel method)

(Q1 2001–Q1 2021)



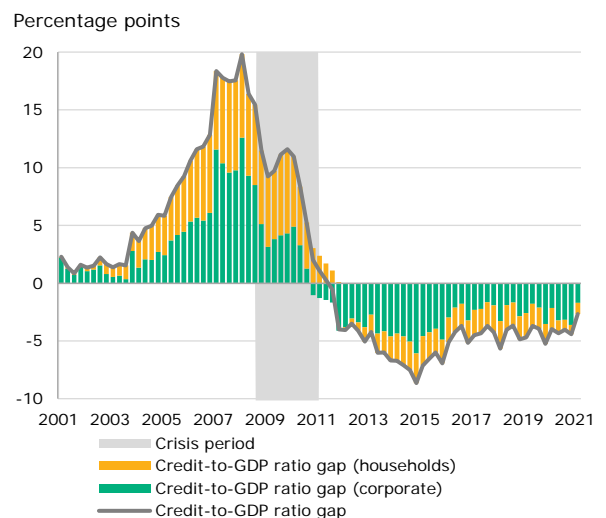
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

Chart C. Core indicator II: Credit to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method) (Q1 2001–Q1 2021)



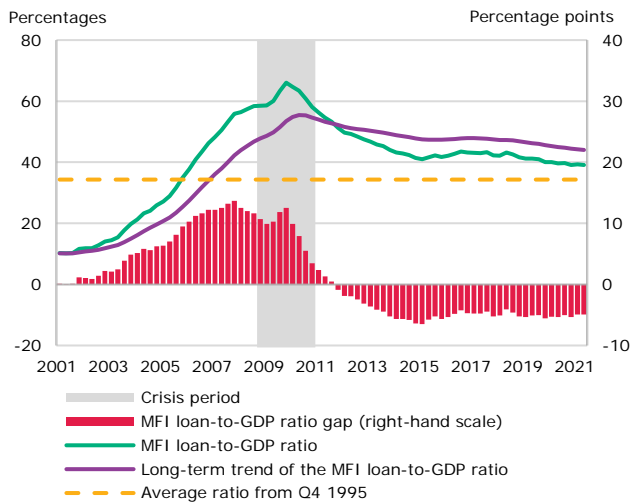
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: the long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart D. Core indicator II: Credit to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method) by sector (Q1 2001–Q1 2021)



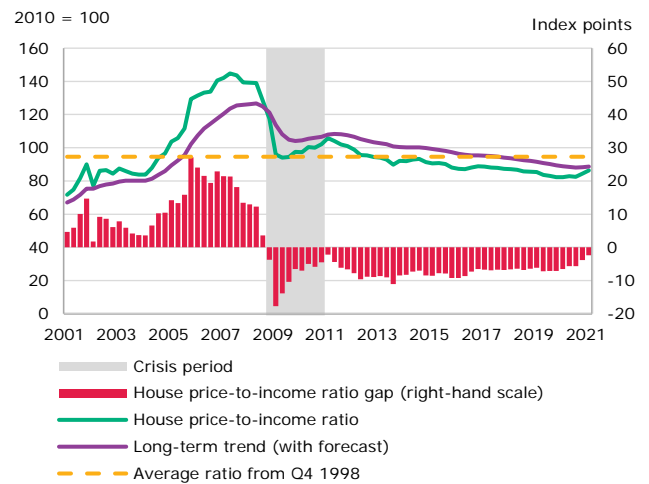
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart E. Additional indicator I: MFI loan to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method) (Q1 2001–Q2 2021)



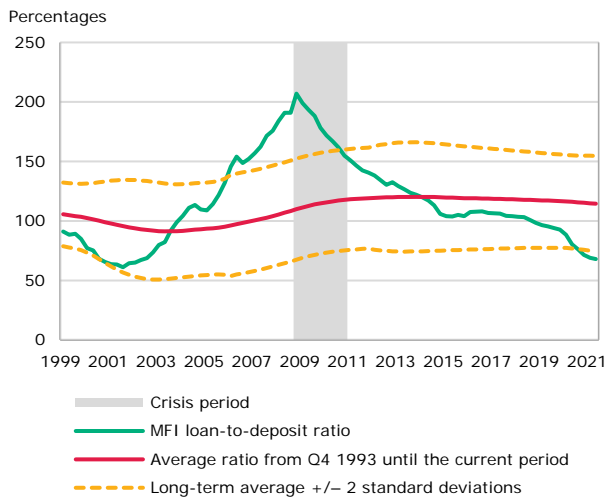
Sources: Statistics Lithuania and Bank of Lithuania calculations.
 Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart F. Additional indicator II: House price-to-income ratio gap (based on the forecast-augmented method) (Q1 2001–Q1 2021)



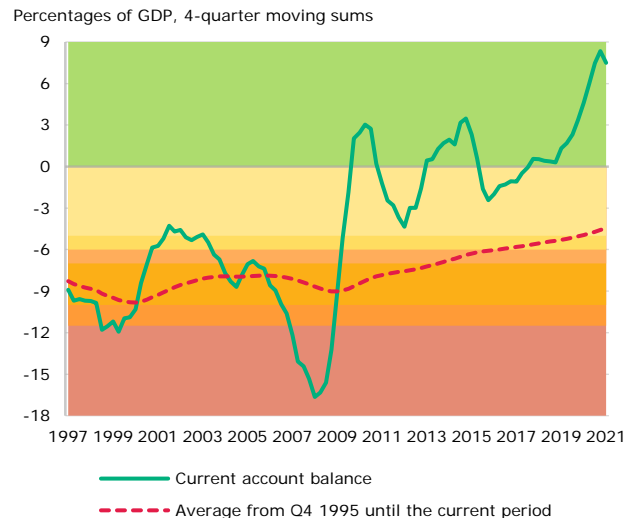
Sources: Statistics Lithuania and Bank of Lithuania calculations.
 Notes: 1) income – household wages and salaries; 2) the long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window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

Chart G. Additional indicator III: Ratio of MFI loans to the private sector and private sector deposits (seasonally adjusted) (Q1 1999–Q2 2021)



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.

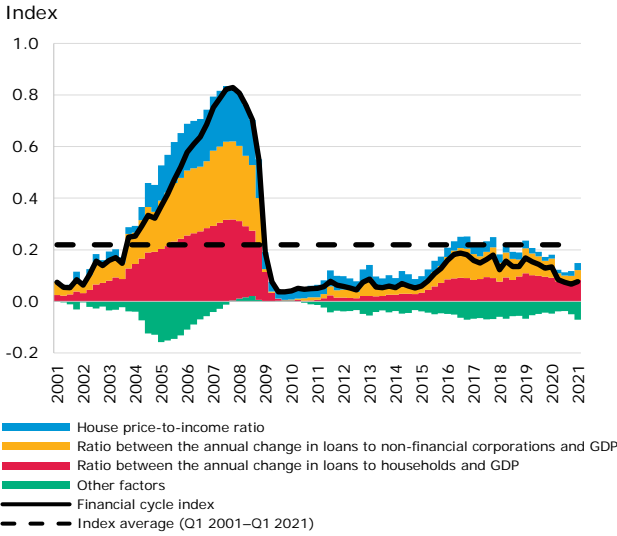
Chart H. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP (Q1 1999–Q1 2021)



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 I. Contributions to Lithuania's financial cycle index

(Q1 2001–Q1 2021)



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).