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SUMMARY OF THE REVIEW

The flow of new loans from monetary financial institutions (MFIs) to the private non-financial sector has increased, but the portfolio of loans to non-financial corporations has not yet fully recovered. While new MFI lending continues to be active, trends in the corporate and household sectors remain divergent, with the MFI loan portfolio to households continuing to grow at a rapid pace, while the volume of loans to companies has not yet reached pre-pandemic levels. On the other hand, credit growth, which covers all loans to non-financial corporations (including from the non-bank sector) and funding through debt securities, has accelerated and fully recovered exceeding the pre-pandemic levels. However, the challenges of the pandemic remain: rising energy and raw material prices, increasing labour costs may lead to lower corporate profitability, business expansion and weaker-than-expected economic growth, leaving the non-financial corporate sector still vulnerable. In addition, the outbreak of Russia's aggression against Ukraine and the increased uncertainty surrounding it could worsen the outlook for corporate borrowing.

Activity in the residential real estate (RE) market is stabilising, but lending and price growth rates are still high. The pace of growth of the MFI housing loan portfolio continues to accelerate and the flow of new housing loans was higher than a quarter earlier. The number of home sales is stabilising, but the rate of price growth continues to increase, and signs of price overvaluation are emerging. On the other hand, lending standards are not easing, the share of home purchases with loans has declined, and affordability has not deteriorated significantly in the face of rapidly rising incomes, so no significant imbalances are currently visible in the housing market. The outbreak of the Russian aggression against Ukraine has brought a lot of uncertainty to the housing market in terms of future demand, prices of building materials and the development of new supply. Meanwhile, the situation in the commercial RE market is stabilising – banks' expectations for commercial RE prices are improving and banks do not expect prices to fall in the near future. Commercial RE rents remained stable in the fourth quarter of 2021, while vacancy rates increased due to increased supply.

From 1 February 2022, the down payment requirement for households taking out the second or subsequent housing loan has been tightened. A higher down payment requirement of at least 30% has been applied to the second and subsequent credit agreements, while exceptions are made for the residents whose balance on each previous loan is less than 50% of the value of the home purchased with that loan; such residents are subject to a down payment requirement of more than 15%. In addition, a new capital requirement – a 2% sectoral systemic risk buffer for the housing loan portfolio – will apply on a consolidated basis to banks and central credit union groups from 1 July 2022.

While the RE market and housing lending activity has continued to pick up, credit trends in the overall economy do not point to the emergence of imbalances in the financial system, and the countercyclical capital buffer rate (CCyB), which remains at 0%, is in line with the current situation in the credit market. While the banking sector's portfolio of loans to non-financial corporations has not yet reached the pre-pandemic levels and the corporate sector has become more vulnerable to geopolitical tensions with Belarus, China and Russia's war against Ukraine, the Bank of Lithuania's targeted measures will more effectively limit the risks to financial stability stemming from the housing market. If overall credit to businesses and households continues to grow at a strong pace once the corporate loan portfolio reaches the pre-pandemic levels, a higher CCyB rate may be considered in order to strengthen the resilience of the banking sector to cyclical risks.

DEVELOPMENT OF CREDIT AND REAL ESTATE MARKETS

Key indicators of imbalances remain at sustainable levels and the financial cycle is in recovery. The gap between credit-to-GDP ratio and its long-term trend remained negative and did not change significantly: it stood at -8.7 percentage points or -3.8 percentage points according to the valuation method (previous quarter: –8.8 percentage points and -3.6 percentage points respectively). The gap between MFI loans to the private non-financial sector and GDP remained unchanged quarter-on-quarter and stood at -5 percentage points at the end of 2021. In view of the slowdown in deposit growth and the acceleration in loan growth, the loan-to-deposit ratio increased to 74% (69.7% in the previous quarter) during the quarter. The ratio of the current account balance to GDP remained positive but declined to 3% of GDP at the end of the third quarter of 2021 (5% in the previous quarter). The house price-to-income ratio deteriorated slightly further during the quarter to 88 (85.8 in the previous quarter), due to the continuing rapid rise in house prices. Taking into account econometric models, the housing price gaps from its long-term trends and relative indicators, the gap between housing prices and fundamental values widened to 9% in the third quarter. The financial cycle index continues to rise and is now in the early stage of recovery.

Growth in the portfolio of MFI loans to non-financial corporations accelerated on the back of a recovery in new flows, especially higher-value loan flows, but remained below the pre-pandemic level. In December 2021, the MFI corporate loan portfolio was 10.6% higher than a year ago (1.2% higher year-on-year in the previous quarter), but still 3.2% lower than in the pre-pandemic period[1], although it was almost in line with the average value of the portfolio over the last three years (0.9% higher). The loan portfolio has been increasing for more and more economic activities. The main contributors to the growth of the total portfolio were transport and storage (+2.8% percentage points), manufacturing (+2% percentage points), RE activities (+1.9 percentage points) and administrative and service activities (+1.9% percentage points). New lending remained active, with the flow of pure new loans to non-financial corporations being 47% higher than in the previous quarter and 55% higher than in the corresponding period of the year before. The flow of higher-value loans increased more rapidly: the quarterly flow of loans of up to €1 million (including renegotiated loans) increased by 7% compared to the corresponding period a year ago and by 18% compared to the previous quarter, while flows of loans of more than €1 million grew by 42% over the year and by 28% over the quarter. Interest rates on pure new loans to non-financial corporations fell slightly, averaging 2.7% per annum in September 2021 (2.8% a quarter earlier). Undertakings also used other alternative sources of finance. According to financial accounts, in the third quarter of 2021, loans from other companies grew by 17% year-on-year (€0.6 billion), trade credits – 3% (€0.2 billion), while debt securities increased by 33% (€0.5 billion).

The portfolio of MFI loans to households increased even more rapidly, mostly due to active provision of housing loans, even though the lending standards remained substantially unchanged. In December 2021, the portfolio of loans to households was 10.7% larger than a year ago, i.e. 1.6 percentage points larger than in the previous quarter. Growth in the total loan portfolio continued to be mainly supported by housing loans: due to the continued strong new lending, the pace of growth in the housing loan portfolio accelerated to 11.7% (0.4 percentage point more compared to the previous quarter) and was the highest since 2009. Overall, the number of new housing loans granted in 2021 was 21% higher than in the previous year, 10% higher in the last quarter than in the corresponding period a year ago and 8% higher than in the previous quarter. The value of new loans granted increased even faster: the flow of pure new housing loans in the fourth quarter of 2021 was a 25% higher than in the corresponding period a year ago and 17% higher than in the previous quarter. The average debt service-to-income (DSTI) and loan-to-value (LTV) ratios for new housing loans remained broadly unchanged, fluctuating around 28% and 75% respectively. On the other hand, there has been a recent downward trend in the share of new loans with the high (80–85%) LTV ratio. The portfolio of consumer and other

[1] February 2020

loans to households started to grow due to an increase in new consumer lending, and in December 2021 it was 5.5% higher than in the corresponding period a year ago (in the previous quarter – 0.4% lower than a year ago). The flow of pure new consumer loans was 65% higher than a year ago and remained significantly unchanged from the previous quarter, at almost 3% lower. Interest rates declined slightly during the quarter, with the annual average interest rate of 2.1% on new housing loans and 8.1% on consumer loans in December 2021 (2.2% and 8.3% respectively a quarter earlier).

The housing market in the fourth quarter of 2021 was slightly quieter due to limited supply and rising prices, but the market is still more active than before the pandemic. According to the Centre of Registers, activity on the housing market is decreasing, but still higher than before the pandemic. In the fourth quarter of 2021, there were 1.2% fewer home sales than in the third quarter of 2021, 6.4% more than in the corresponding period of 2020 and 14.1% more than in the corresponding pre-pandemic period in 2019. According to more recent data, the number of sales in January 2022 was 23% lower than the average monthly figure for 2021, which could be influenced by seasonality, as buyers completed their transactions before the end of 2021. The share of homes bought with a loan decreased during the quarter to 54.8% of the value of homes bought in the fourth quarter of 2021[2] (3.6% percentage points less than in the third quarter), a decrease driven by the result in December, when only 46% of homes were bought with a loan. Activity in the primary apartment market in Vilnius has been declining in the fourth quarter of 2021, with 3.8% fewer reservations than in the third quarter, 23.5% fewer than in the fourth quarter of 2020 and 8.4% more than in the corresponding pre-pandemic period of 2019. The number of apartment reservations was 18.1% lower in January 2022 than in December 2021. Although activity in the primary market is decreasing and the volume of reservations is returning to pre-pandemic levels, the stock of apartments is not being significantly replenished, with around 3.6 thousand apartments currently unsold, 17.2% less than in January 2021. Before 2021, such a level of stock was last witnessed in 2016. In the recent months, the decline in housing market activity has been influenced by a faster rise in the prices of housing and deteriorating affordability, as well as reduced access to suitable housing due to insufficient replenishment of housing supply.

The annual growth rate of house prices continues to accelerate, and prices are moving away from values based on economic factors, signalling that imbalances may be developing in the market. According to Statistics Lithuania, the annual housing price growth accelerated and stood at 18.9% in the third quarter of 2021 (5.6 percentage points higher than in the second quarter and 12.5 percentage points higher than in the third quarter of 2020) and was the highest since 2007. According to the Repeat Sales House Price Index (RSHPI) of the Bank of Lithuania, the annual price growth rate continued to accelerate and reached 24.3% in January 2022, while the data of the real estate market participant Ober-Haus show that the prices rose by 22.6% during this period. The gap between housing prices and fundamental values was 9% in the third quarter of 2021, and with the prices continuing to rise rapidly in the fourth quarter, the gap is likely to widen further, possibly leading to overly optimistic expectations of the public regarding further price increases. This can lead to a gap between the housing market and the overall economic development and to the increasing risk of a market correction. According to the data of the bank survey conducted in the fourth quarter of 2021, all surveyed banks expect a rise in the prices of new housing, while eight out of nine expect a rise in the prices of old housing over the coming year. In addition, all the banks surveyed observe imbalances in the residential RE market.

According to the European Systemic Risk Board (ESRB), the Lithuanian housing market is at the stage of firm expansion and the level of risk posed by the market is medium. The pace of house price growth in Lithuania is currently among the fastest in the EU (only the Czech Republic recorded faster growth in the third quarter of 2021), but the ESRB's report of February 2022 assesses the level of risk posed by the housing market in Lithuania as medium. The ESRB considers that the macroprudential policy measures currently in place are appropriate and sufficient but stresses the importance of close monitoring of the market in the context of rapidly rising prices and lending volumes. In addition, the ESRB identifies tax measures and a

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[2] In terms of the number of sales, 38% of dwellings were bought with a loan, but excluding lower value dwellings (up to EUR 50 thousand), this share accounts for 59%.

stricter down payment requirement for housing loans taken out for investment purposes as possible means to curb speculative demand[3].

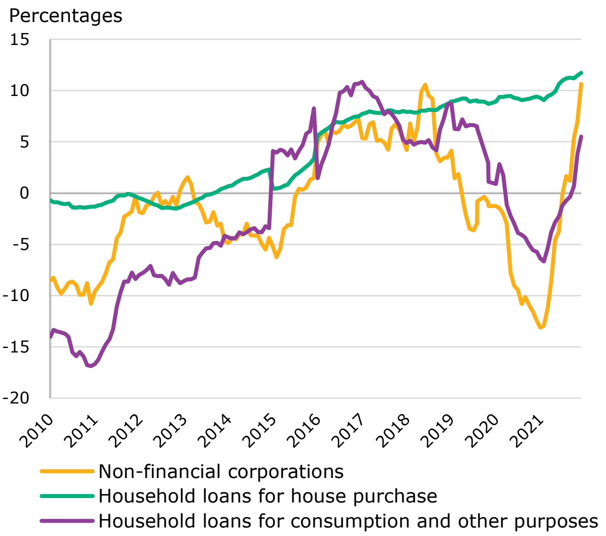
In the fourth quarter of 2021, banks' expectations for future developments in commercial RE values improved, while the share of unlet office space increased due to rising supply. None of the commercial banks that participated in the survey conducted by the Bank of Lithuania in the fourth quarter of 2021 indicated that they expected commercial property prices to fall in the coming year, while the majority (78%) of the respondents expected the prices to rise. For comparison, at the beginning of 2021, half of the banks expected commercial property prices to fall. The office vacancy rate in Vilnius increased by 2.5 percentage points to 7.8% in the fourth quarter of 2021 due to an increase in the supply of Class B offices[4], but the vacancy rate of Class A offices decreased. In the meantime, office rents remained largely unchanged over the period. With inflation rising rapidly, uncertainty in the commercial RE market is growing with regards to future yields, but the market has weathered the pandemic and is returning to business as usual.

[3] A stricter 30% down payment requirement for second and subsequent housing loans entered into force on 1 February 2022.

[4] Based on Newsec data.

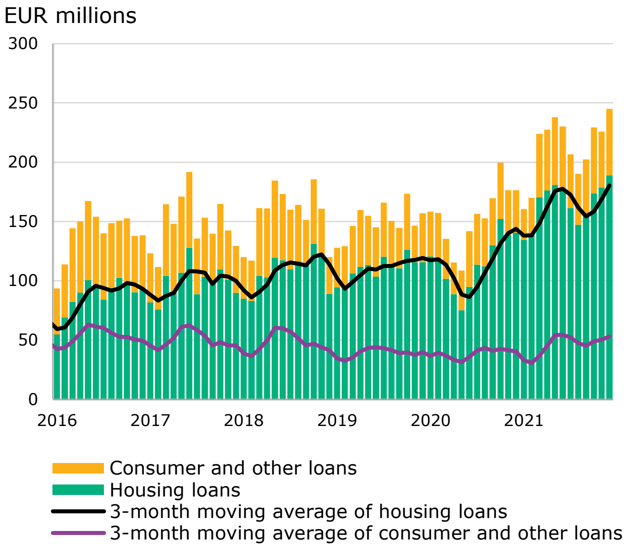
ANNEX 1. TRENDS IN CREDIT AND HOUSING MARKETS

Chart 1. Annual growth of the portfolio of MFI loans to non-financial corporations and households (January 2010 – December 2021)



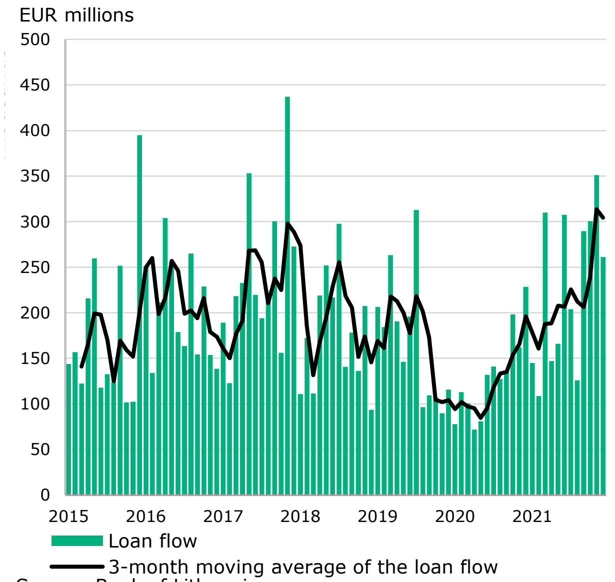
Source: Bank of Lithuania.

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



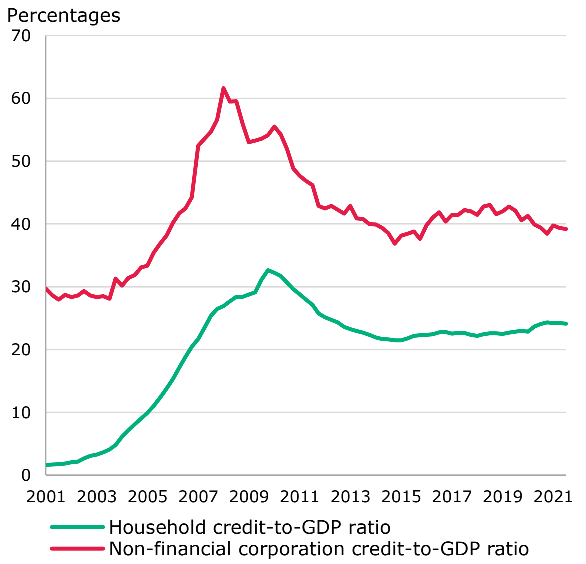
Source: Bank of Lithuania

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



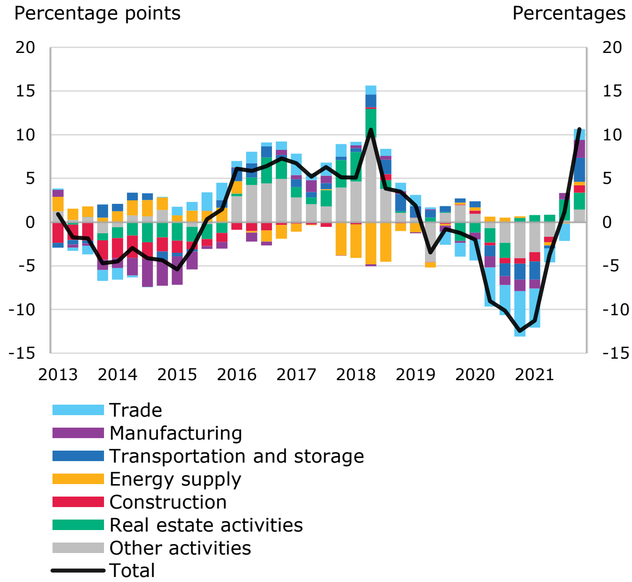
Source: Bank of Lithuania.

Chart 4. Credit-to-GDP ratio of non-financial corporations and households (Q1 2001 – Q3 2021)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

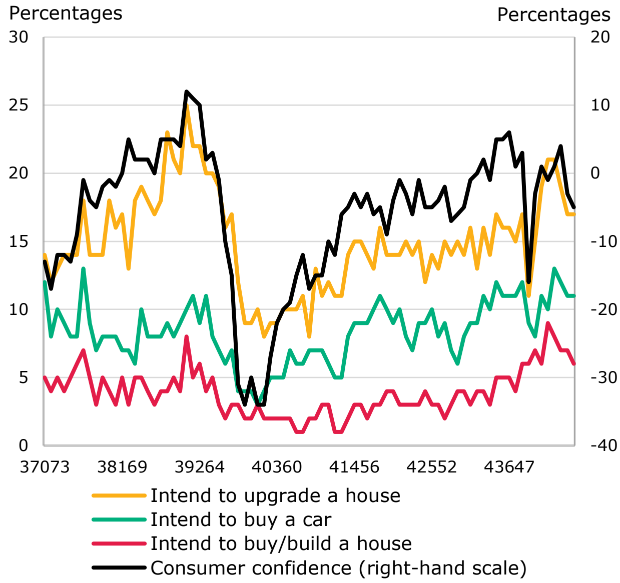
Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity (Q1 2013 – Q3 2021)



Source: Bank of Lithuania calculations.

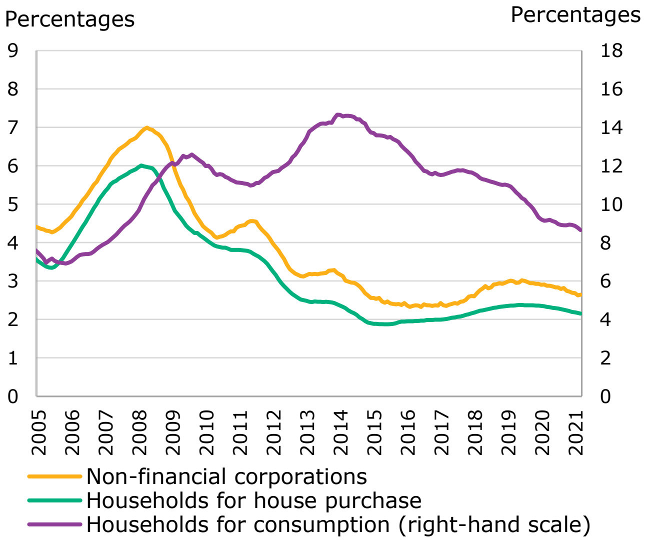
Chart 6. Consumer survey results

(July 2001 – January 2021)



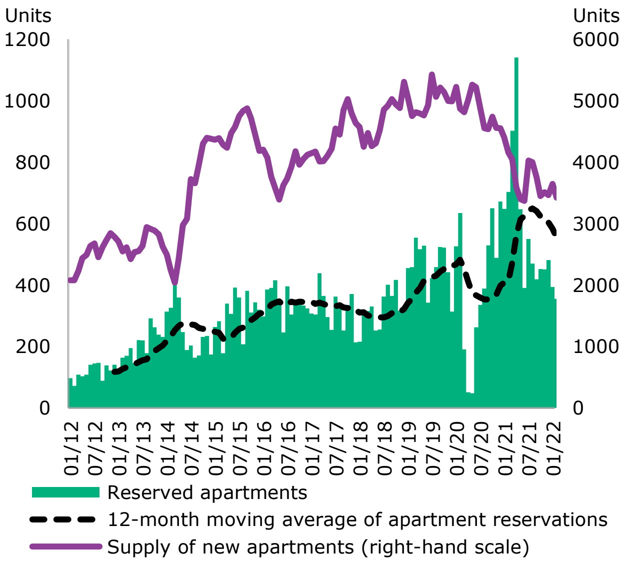
Sources: Statistics Lithuania and Bank of Lithuania calculations.

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



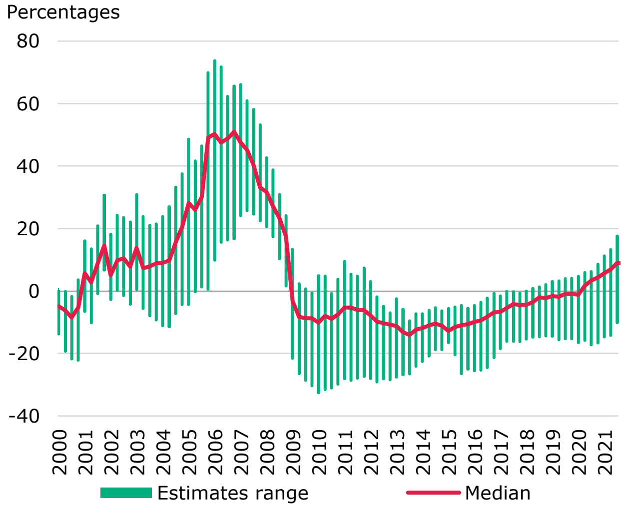
Source: Bank of Lithuania.

Chart 8. Number of new apartments reserved and in Vilnius primary market and supply of apartments (January 2012 – January 2022)



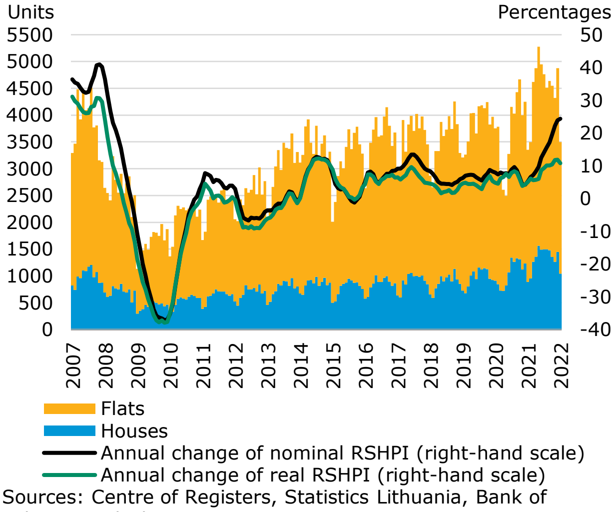
Source: Inreal.

Chart 9. Gap between actual house prices and their fundamental values
(Q1 2005 – Q3 2021)



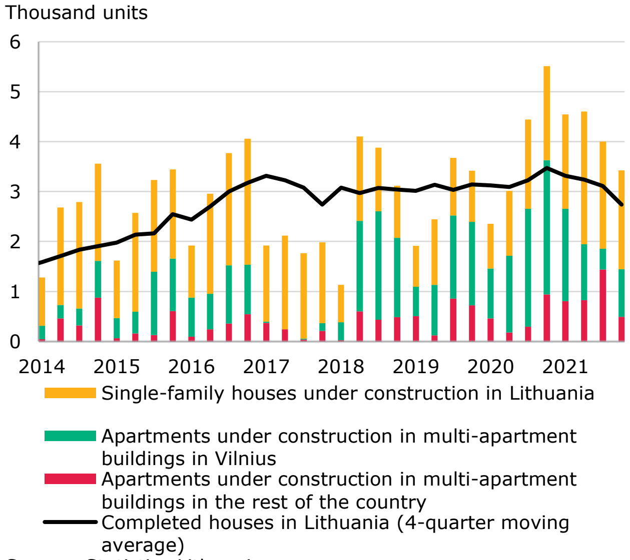
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Calculated based on the house price-to-rent ratio, house price-to-income ratio, econometric models and the HP filter

Chart 10. Homes sold in a month in Lithuania and annual change in house prices
(January 2007 – January 2022)



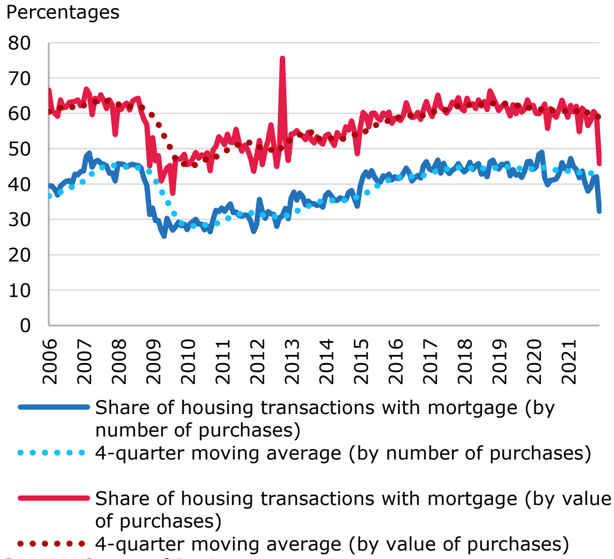
Sources: Centre of Registers, Statistics Lithuania, Bank of Lithuania calculations.
Note: real RSHPI calculated by deflating nominal RSHPI using the HICP.

Chart 11. Number of under-construction and completed houses in Lithuania
(Q1 2014 – Q4 2021)



Source: Statistics Lithuania.

Chart 12. Share of housing transactions with mortgage against all purchases
(January 2006 – December 2021)

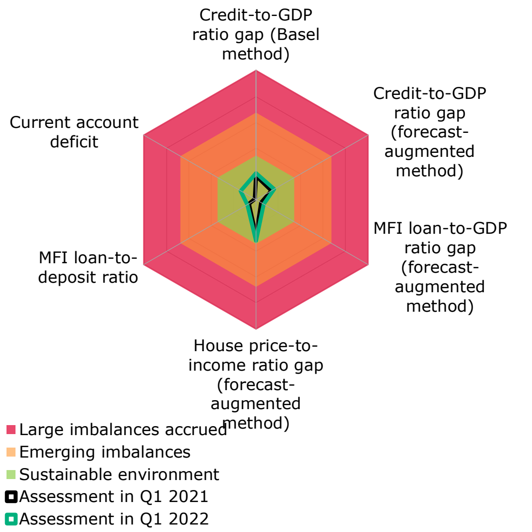


Source: Centre of Registers.

ANNEX 2. INDICATORS OF CREDIT AND HOUSING MARKET IMBALANCES

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

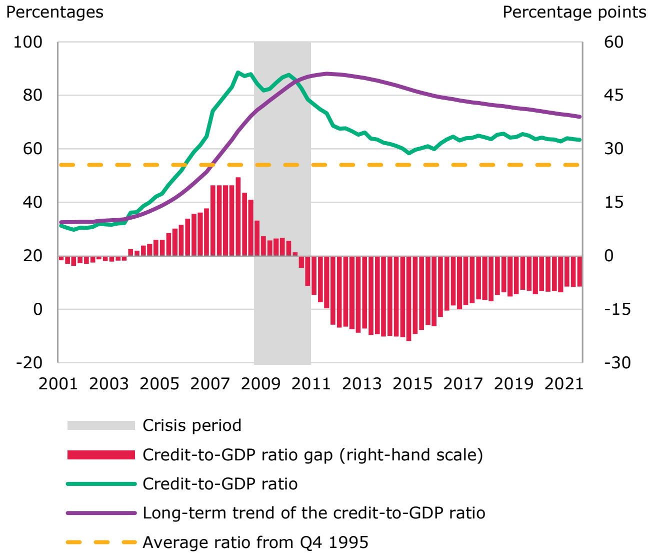
(Q1 2022)



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.

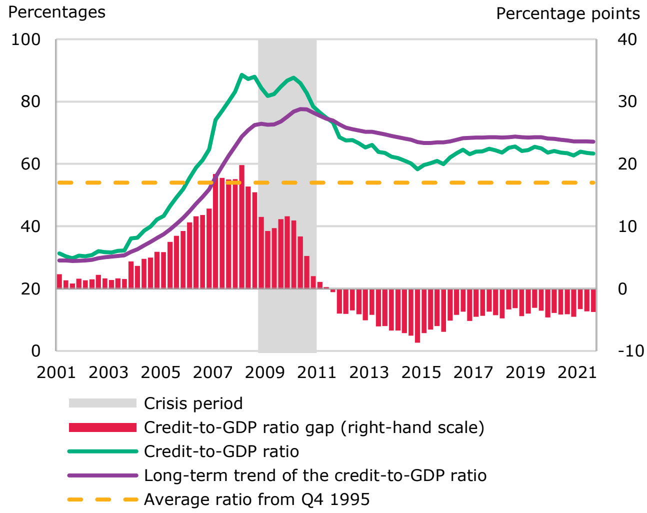
Chart B. Core indicator I: Credit to the private non-financial sector-to-GDP gap (based on the standardised Basel model)

(Q1 2001 – Q3 2021)



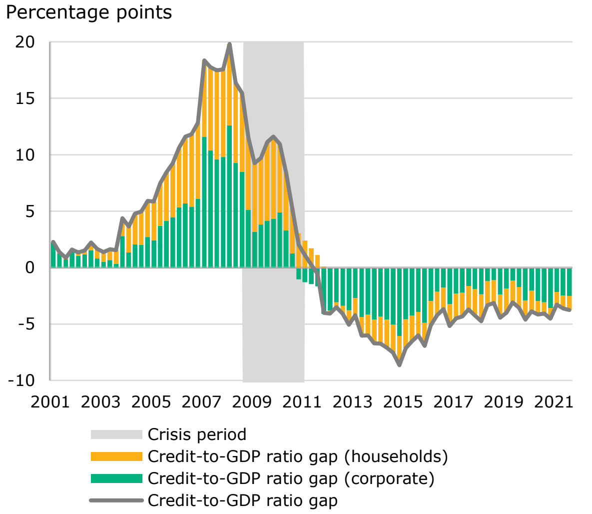
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

Chart C. Core indicator II: Credit to the private non-financial sector-to-GDP gap (based on the forecast-augmented method)
(Q1 2001 – Q3 2021)



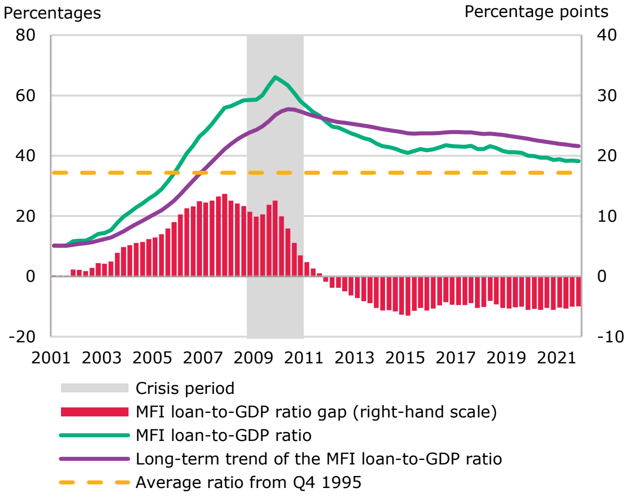
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: the long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart D. Core indicator II: Credit to the private non-financial sector-to-GDP gap (based on the forecast-augmented method) by sector
(Q1 2001 – Q3 2021)



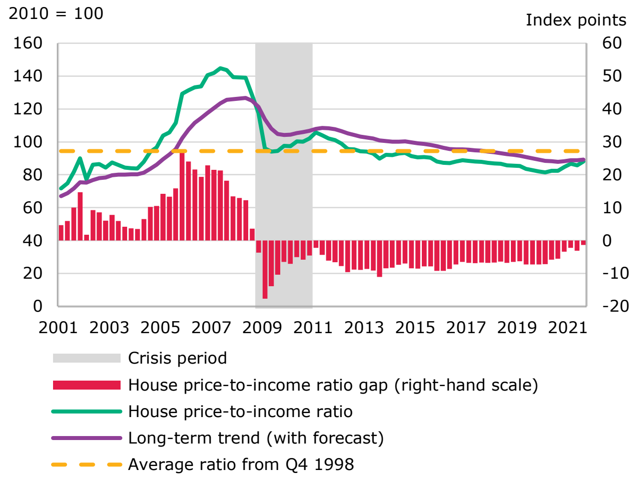
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted

Chart E. Core indicator I: MFI loan to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001 – Q3 2021)



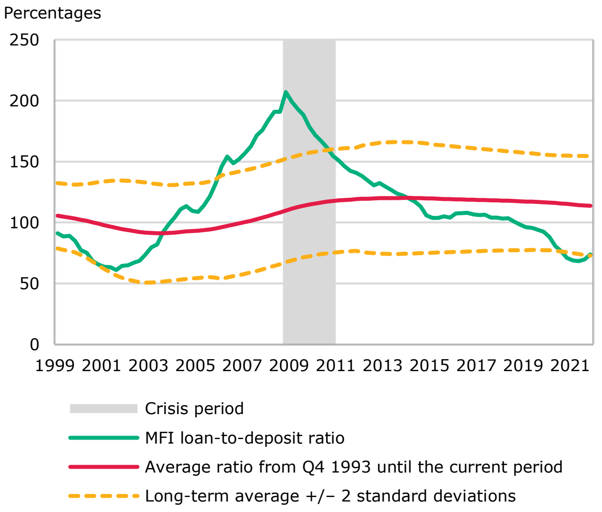
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart F. Additional indicator II: House price-to-income ratio gap (based on the forecast-augmented method)
(Q1 2001 – Q3 2021)



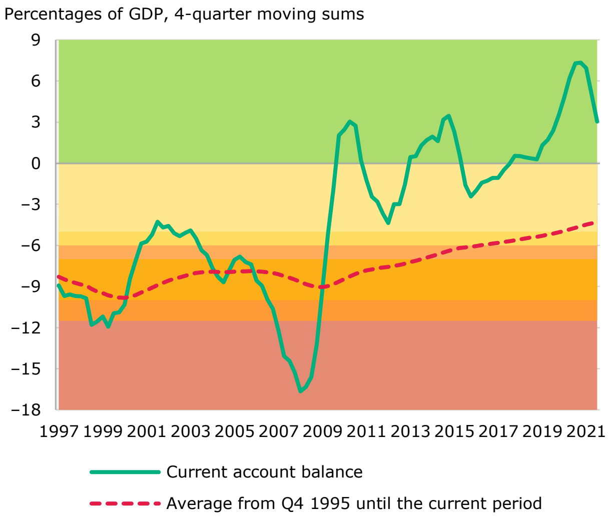
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Notes: 1) income – household wages and salaries; 2) the long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window 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 – Q3 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.

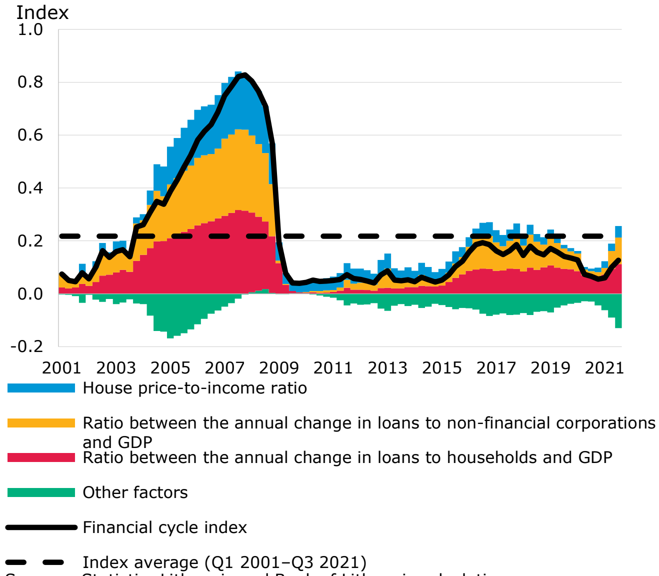
Chart H. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP
(Q1 1997 – Q3 2021)



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. Lithuania's financial cycle index and its drivers (total credit to non-financial corporations and households)

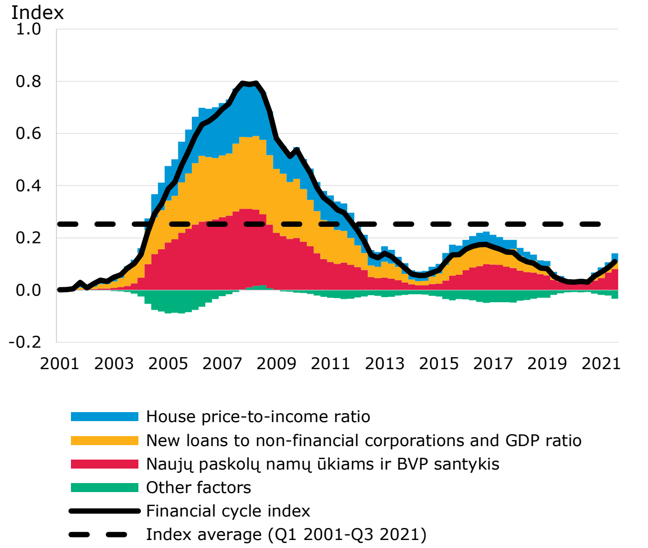
(Q1 2001 – Q3 2021)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: 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).

Chart J. Lithuania's financial cycle index and its drivers (MFI loans to non-financial corporations and households)

(Q1 2001 – Q3 2021)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: the financial cycle index is calculated having regard to MFI loans granted to non-financial corporations and households.