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CREDIT AND REAL ESTATE MARKET REVIEW

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SUMMARY OF THE REVIEW

Lending by monetary financial institutions (MFIs) to the non-financial private sector has been active despite the outbreak of war in Ukraine, although the war remains a source of uncertainty about future lending developments. New MFI lending continues to be active, contributing to faster growth rates of MFI portfolios of loans to non-financial corporations and households. Credit to corporations, which covers all loans granted to them (including from the non-bank sector) and funding through debt securities, has also increased. As a result, the recent growth in credit to the private sector has become broader, covering both the household and corporate sectors. However, credit to households is still in a higher phase of the cycle. In addition to the increased aggregate demand, the rising inflation rate is also contributing to the growing demand for credit, which has even made real credit growth negative. In the future, inflation and the shrinking liquidity buffers accumulated by corporations during the COVID-19 pandemic will contribute to higher credit demand, but uncertainty about aggregate demand will continue to be driven by the risk of an economic slowdown in the aftermath of war.

House prices are still showing signs of overvaluation, but the pace of price growth is no longer accelerating as sales have returned to the pre-pandemic levels. Based on more recent data, house price growth in July stood at 22–23%. The price gap from the median of fundamentals in the first quarter of 2022 shows that prices are overvalued by 6.5%, which in turn indicates that there are still imbalances in the housing market. The strong pace of new mortgage lending continues to contribute to demand in the housing market, while the share of own funds in purchases fell slightly during the quarter. Overall, the number of home sales has returned to the pre-pandemic levels, reflecting a reduction in demand, but the gap between demand and supply remains significant. Russia's war against Ukraine has brought a lot of uncertainty into the housing market in terms of future prices of building materials and the development of new housing supply, so that, even with the fall in sales, new housing supply remains limited. The situation in the commercial real estate (RE) market remained unchanged during the quarter.

Taking into account the broader financial cycle, the growth of the economic cycle from the second half of 2020 onwards, the high profitability of banks and the more distinct background of economic risks in the near future, the Bank of Lithuania is restoring the countercyclical capital buffer (CCyB) rate to the pre-pandemic level of 1%, thereby strengthening the resilience of the banking sector. The higher CCyB rate will apply after the standard transitional period of 12 months, i. e. on 1 October 2023. This measure is necessary given the broad-based growth of the financial cycle, as a recovery in lending to businesses is observed alongside the continued strong growth in lending to households. At the same time, the country's economic cycle remains in an upswing, as reflected in real GDP growth, output gap, labour market, inflation, and other indicators, while the performance of the domestic banking sector remains strong. Additional resilience needs are also reflected in the current heightened downside risks to growth related to inflationary phenomena and the consequences of Russia's war. These conditions lead to the need for the 1% CCyB rate for banks' credit exposures in Lithuania, which would be released in the event of a significant economic or financial shock to help banks withstand credit losses and support lending.

Raising the CCyB rate to 1% in the environment of elevated bank profitability will have a modest or insignificant effect on lending and interest rates, but the positive effect on the long-term development of the economy through increased bank resilience would be much stronger. In the short term, the annual growth of the corporate credit portfolio could slow down to 2.5 percentage points, that of the households to 1 percentage point and the interest rate could rise to 0.15 percentage point. However, the likelihood of these effects is minimised by the fact that banks have a sufficient voluntary capital buffer (7 percentage points on average above the existing capital requirements, provided that the profits of the second half of 2022 are included) and are profitable, and rising interest rates further strengthen profitability prospects.

In order to strengthen the resilience of the institutions with the largest portfolios of housing loans to emerging risks in the housing sector, the 2% sectoral systemic risk buffer (SRR) for credit

institutions' portfolios of housing loans to individuals, which entered into force on 1 July 2022, will continue to apply. An additional 2% sectoral SRR on the housing loan portfolio remains necessary to ensure the resilience of the financial system to increased cyclical and structural risks in the housing market.

DEVELOPMENT OF CREDIT AND REAL ESTATE MARKETS

Key indicators of financial system imbalances remain at sustainable levels, but the growth of financial cycle is broadening. The gap between broad credit-to-GDP ratio and its long-term trend has turned less negative in the first quarter of 2022 and stood at −11 or −5.6 percentage points, depending on the method of assessment, while the gap between MFI loans to the private non-financial sector-to-GDP ratio and its long-term trend widened to −5.2 percentage points in the second quarter of 2022. The negative gaps indicate that there is no excess credit in the economy. The loan-to-deposit ratio increased to 80.2% during the quarter (from 78% in the previous quarter), driven by the faster loan growth and slower deposit growth, but it still remained at the sustainable level. The current account balance-to-GDP ratio turned negative, reaching −1.3% (in the previous quarter it stood at 1.4%) during the first quarter of 2022. The house price-to-income ratio index, which measures housing affordability, has not changed significantly during the quarter and stood at 89.6 (90 in the previous quarter), while the gap between the indicator and its long-term trend turned negative, but remained close to the positive boundary that indicates emerging imbalances. Taking into account econometric models, gaps with long-term trends and relative indicators, the gap between house prices and fundamental values narrowed slightly in the first quarter of 2022, but was still positive at 6.5%, indicating that prices are still somewhat out of line with the fundamental factors. The financial cycle index is gradually settling into an upturn, but the growth of the financial cycle is becoming broader due to the recovery in corporate lending.

The growth of the MFI portfolio of loans to non-financial corporations is further accelerated by an increase in new lending flows. In June 2022, the MFI corporate loan portfolio was 17.5% (or €1.4 billion) higher than a year ago (a quarter ago it was 16.2% larger than a year earlier), although high inflation led to negative real growth of −0.9%. The main contributors to the increase in the total nominal portfolio were manufacturing (4 percentage points), trade (3.8 percentage points), transport and storage (3 percentage points) and real estate activities (2.1 percentage points). Although business expectations are still subdued due to heightened uncertainty, new lending flows are still elevated, supported by an increased need for working capital due to higher prices. In the second quarter of 2022, the flow of pure new loans to non-financial corporations was 36% higher than in the corresponding period a year earlier and 39% higher than in the previous quarter. Growth in lower-value loans accelerated, with the quarterly flow of loans of up to €1 million (including renegotiations) increasing by 11% compared to the same period a year earlier, while that for loans above €1 million grew by 3%. Average interest rates on pure new loans to non-financial corporations rose slightly to 3.3% in June, although the annual average interest rate remained at 2.8%. In addition to bank loans, other corporate financial liabilities also increased. According to financial accounts, in the first quarter of 2022, trade credits increased by 21% (€2.9 billion) year-on-year, debt securities issued – by 29% (€0.5 billion) and other payables - by 27% (€1.9 billion).

The MFI portfolio of loans to households continued to grow rapidly, driven by continued active lending for housing and consumer loans, while the share of riskier loans has stopped rising. In June 2022, the annual growth of portfolio of loans to households was 11.5% (0.2 percentage point higher than a quarter before). Growth of the total portfolio of loans to households continued to be mainly supported by housing loans, the portfolio of which grew by 12.2% annually (the growth was 0.1 percentage point lower than in the previous quarter), which was one of the highest growth rates since 2009. However, the number of new housing loans has fallen slightly over the year, with the number of loans in the second quarter of 2022 a tenth lower than a year earlier, although still 9.1% higher than in the previous quarter. The average value of loans granted has started to stabilise amid a slowdown in new lending, with the flow of pure new housing loans in the second quarter of 2022 4.7% higher than in the corresponding period a year earlier and 7% higher than in the previous quarter. The average debt service-to-income (DSTI) and loan-to-value (LTV) ratios of new housing loans have not changed significantly, fluctuating at around 28% and 77%, respectively, but there has been a slight increase in the DSTI, while the recent increase in the share of riskier loans with high LTVs (>80%) and longer loan maturities (>25 years) has stalled. The annual growth rate of the portfolio of consumer and other loans to households accelerated to 8.5% (6.4% a quarter ago) in June 2022, driven by an increasing flow of new consumer loans. The quarterly flow of pure new consumer loans was 79% higher than a year earlier and 37% higher than in the previous quarter. Interest rates started to rise, with the average interest rate on new housing loans at 2.2% and on consumer loans at 8.6% in June 2022, compared to an annual average of 2.1% and 8.2% respectively.

The number of houses sold in the second quarter of 2022 has subsided towards the pre-pandemic levels, but new housing supply is still limited. According to the data of the Centre of Registers, activity on the housing market is returning to the pre-pandemic levels. In the second quarter of 2022, 19.6% fewer houses were sold than in the second quarter of 2021 and almost the same (2.9% more) than in the pre-pandemic second quarter of 2019. According to more recent data, the number of houses sold in July 2022 was 16.5% lower than the average monthly figure in 2021. The share of houses bought with a loan[1] increased slightly during the quarter and accounted for 52.2% of the value of houses bought in the second quarter of 2022 (up by 2.3 percentage points compared to the first quarter). Activity in the Vilnius primary apartment market has been declining over the period, with 68.5% fewer reservations than in the second quarter of 2021 and 50.6% fewer than in the corresponding period before the pandemic in 2019. The sharp drop in sales was due to the outbreak of Russia's war against Ukraine, which has had a negative impact on the buyers' willingness to buy a home under construction, the increase in construction prices, which has led to the uncertainty of the final price of the home, and the deterioration of affordability due to the rapid price growth. According to more recent data, the number of reservations in July was the lowest since 2012 (excluding the first months of the pandemic when reservations were not made due to the quarantine). The stock of new apartments in the primary market in Vilnius is not being significantly replenished: in July, around 3.6 thousand apartments were unsold, 9.9% less than in July 2021. The extremely fast rate of growth of residential construction prices (18.9% in June) is making it more difficult to construct new dwellings, and supply is likely to remain limited in the near future.

The annual rate of housing price growth continues to be strong, while prices remain out of line with the economically driven values, signalling slowly emerging imbalances in the market. According to data from Statistics Lithuania, the annual housing price growth in the first quarter of 2022 amounted to 19.1% (a decrease of 0.7 percentage point than a quarter ago and an increase of 7.1 percentage points than in the first quarter of 2021) and was one of the highest since 2007. According to the Bank of Lithuania's repeat sales housing price index (RSHPI), the annual price growth rate is still strong and amounted to 22.9% in July 2022, while the data of the real estate market participant UAB OBER-HAUS nekilnojamas turtas show that the price growth rate in the given period was 22.3%. The gap between housing prices and their fundamental values (based on the median of six indicators) in the first quarter of 2022 was 6.5%. With prices having been out of line with fundamental factors for some time now, and with the rate of price growth not slowing down significantly, imbalances in the housing market continue to persist. If prices continue to rise rapidly, this could lead to an even wider market gap compared to the overall economic development and a higher risk of a market correction. According to the bank lending survey of Q2 2022, all surveyed banks expected a growth in new-construction housing prices in the upcoming year, while 7 of 9 banks expected a growth in old-construction housing prices. In addition, all banks surveyed see imbalances in the residential RE market.

In the first quarter of 2022, the banks surveyed did not observe any imbalances in the commercial real estate market, and the share of vacant offices decreased. Banks' expectations for commercial real estate prices remained unchanged during the quarter. None of the commercial banks surveyed by the Bank of Lithuania in the second quarter of 2022 indicated that they expect commercial property prices to fall in the coming years, while the majority of respondents (78%) believe that they will rise. The share of vacant offices in Vilnius decreased by 4.3 percentage points to 4.8%[2] in the second quarter of 2022, mainly due to the

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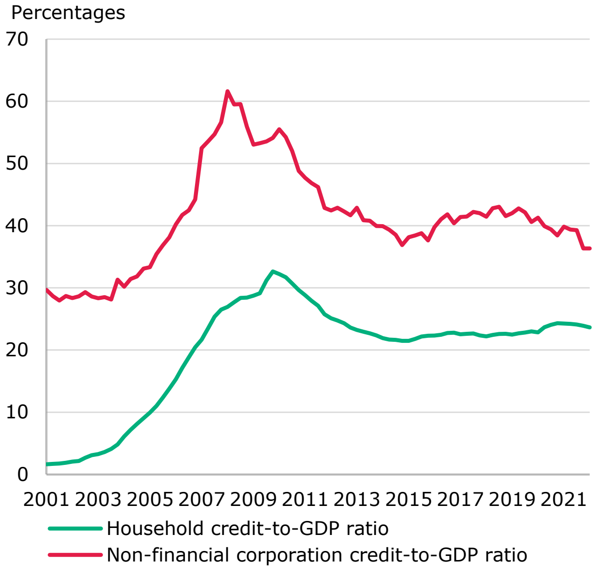
[1] Due to changes in the mortgage register, the share of homes purchased with a loan is lower than described in the previous surveys throughout the whole period under review.

[2] Based on Colliers data.

decrease in vacancy rates for class B offices. Uncertainty in the commercial RE market is slightly elevated due to the market's links to the overall economic development, the increased risk of a slowdown in economic growth due to the soaring inflation and the impact of Russia's war against Ukraine on the economy.

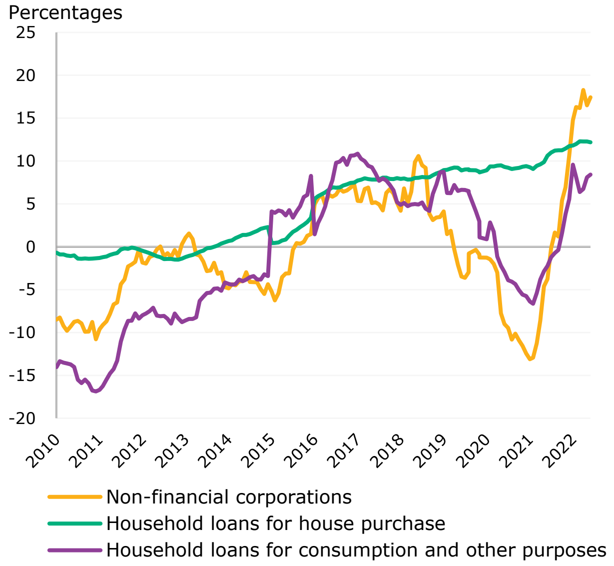
ANNEX 1. CREDIT AND HOUSING MARKET TRENDS

Chart 1. Credit-to-GDP ratio of non-financial corporations and households
(Q1 2001 – Q1 2022)



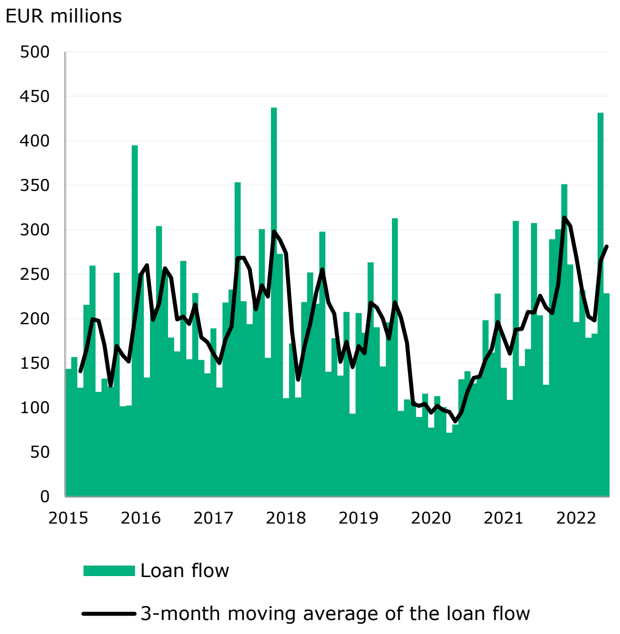
Sources: Statistics Lithuania and Bank of Lithuania calculations.

Chart 2. Annual growth of the portfolio of MFI loans to non-financial corporations and households
(January 2010 – June 2022)



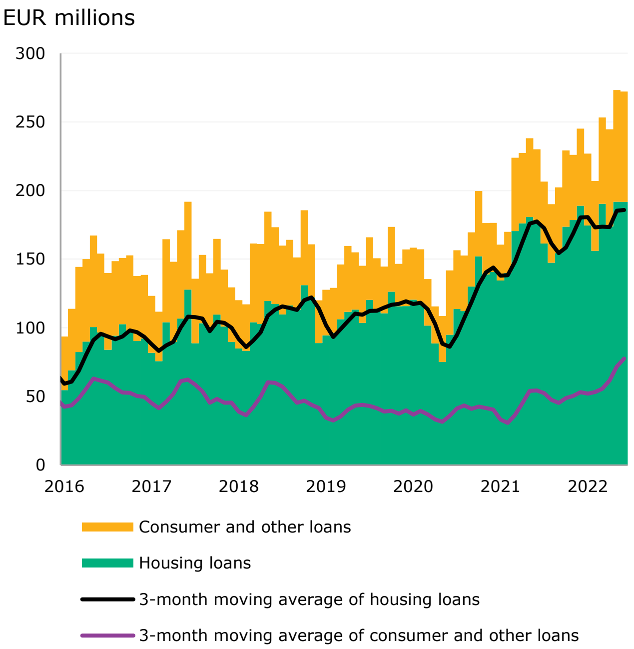
Source: Bank of Lithuania.

Chart 3. Monthly flow of pure new MFI loans to non-financial corporations
(January 2016 – June 2022)



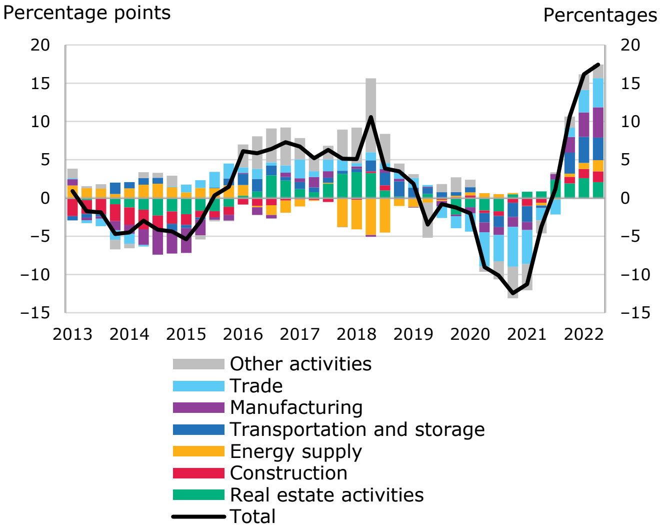
Source: Bank of Lithuania.

Chart 4. Monthly flow of pure new MFI loans to households
(January 2016 – June 2022)



Source: Bank of Lithuania

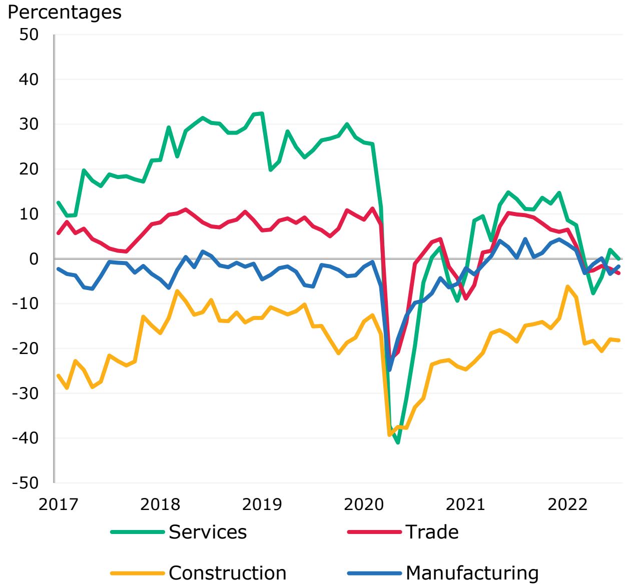
Chart 5. Annual change in the portfolio of MFI loans to non-financial corporations by economic activity
(Q1 2013 – Q2 2022)



Source: Bank of Lithuania calculations.

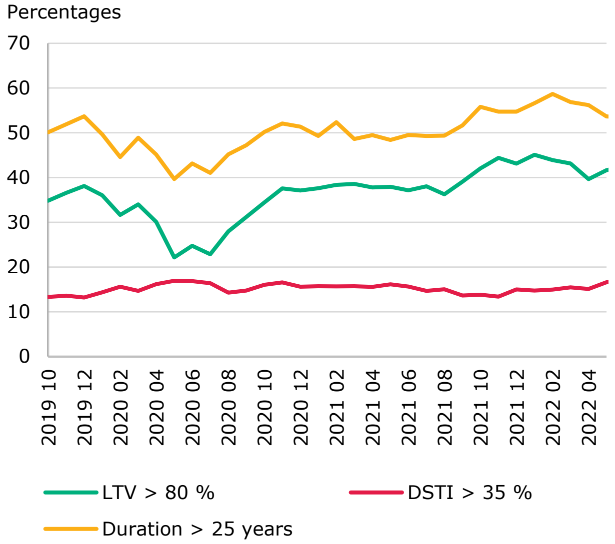
Chart 6. Business confidence indicator

(January 2017 – July 2022)



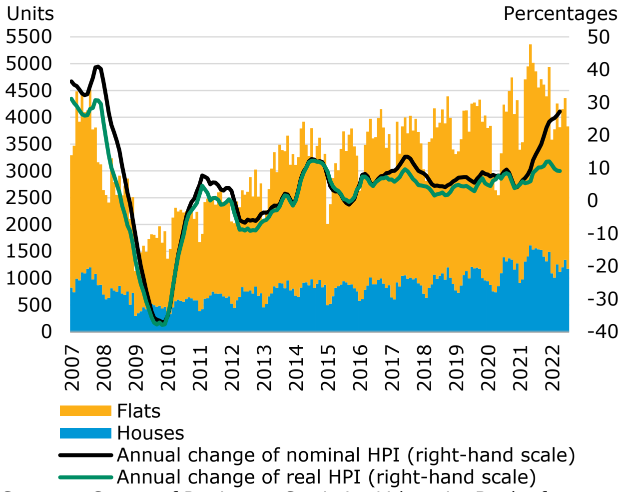
Source: European Commission.

Chart 7. Share of loans with high LTV, DSTI ratio and long loan duration
(October 2019 – May 2022)



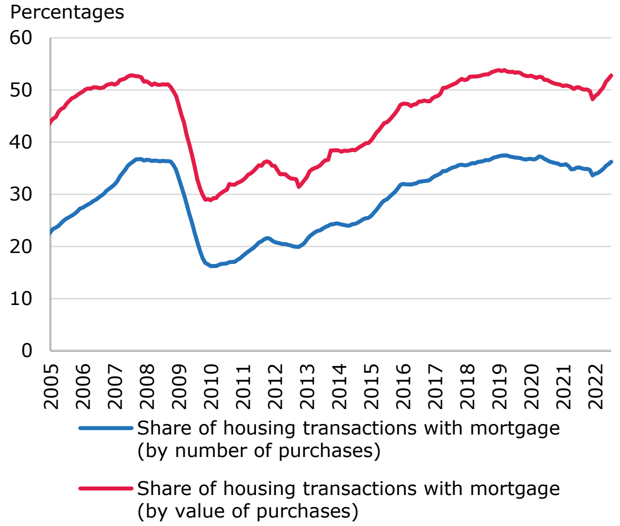
Source: Bank of Lithuania.

Chart 8. Apartments sold in a month in Lithuania and annual change in house prices
(January 2007 – July 2022)



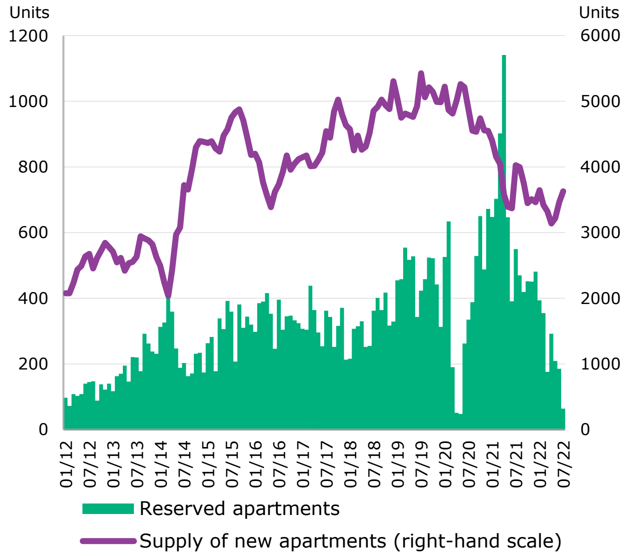
Sources: Centre of Registers, Statistics Lithuania, Bank of Lithuania calculations.
Notes: HPI - house price index. Real HPI calculated by deflating nominal HPI using the HICP.

Chart 9. Share of housing transactions with mortgage against all purchases
(January 2006 – July 2022)



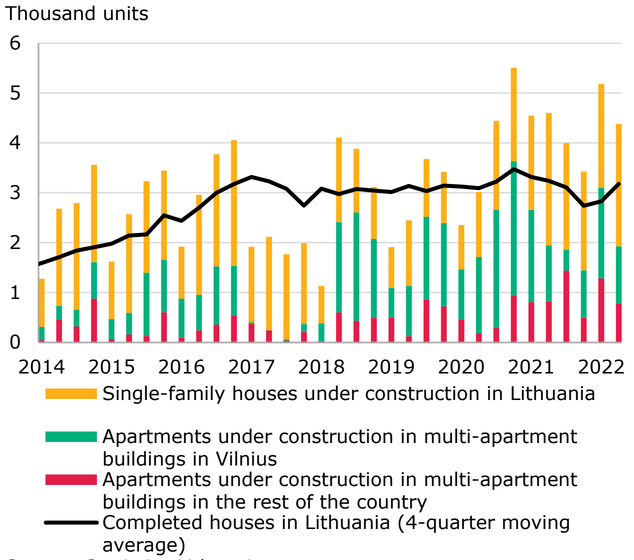
Source: Centre of Registers.
Note: 12-month moving average.

Chart 10. Number of new apartments reserved in Vilnius primary market and supply of apartments
(January 2012 – July 2022)



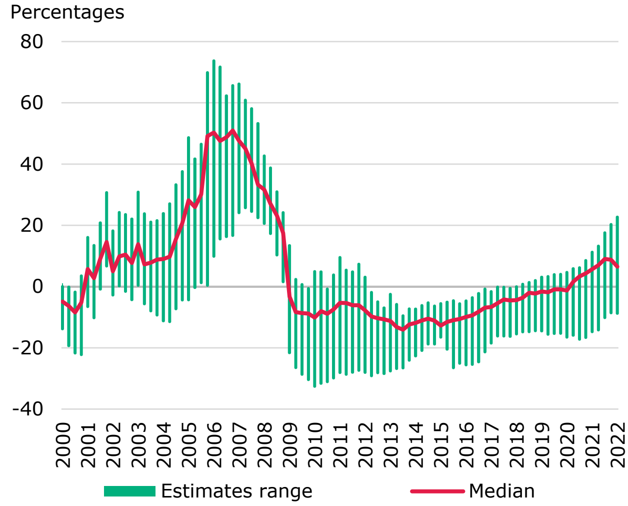
Source: Inreal.

Chart 11. Number of under-construction and completed houses in Lithuania
(Q1 2014 – Q2 2022)



Source: Statistics Lithuania.

Chart 12. Gap between actual house prices and their fundamental values
(Q1 2005 – Q1 2022)

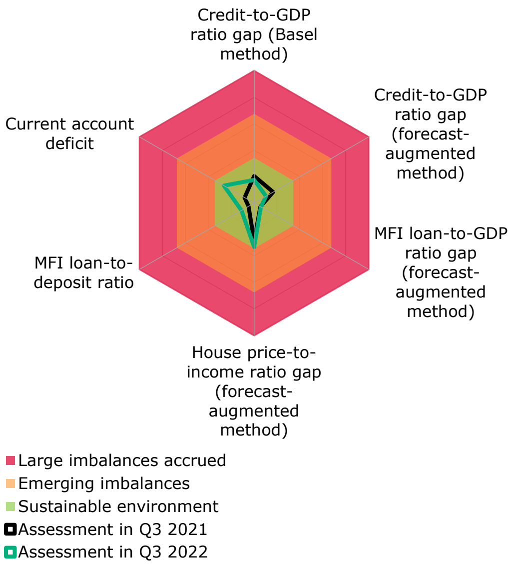


Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: Calculated based on the house price-to-rent ratio, house price-to-income ratio, econometric models and the HP filter.

ANNEX 2. CREDIT AND HOUSING MARKET IMBALANCES

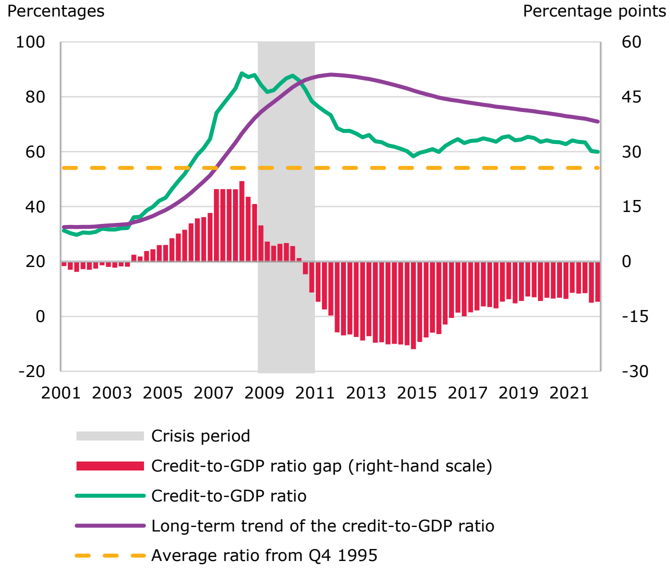
Chart A. Evaluation of credit market imbalances based on core and additional indicators

(Q3 2022)



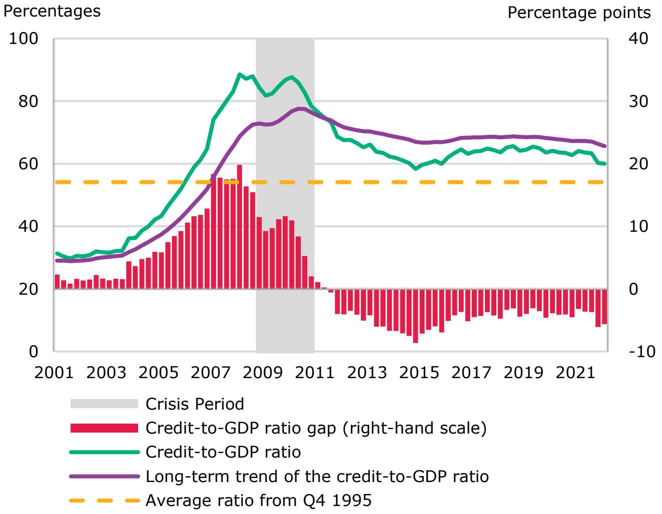
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: axes are scaled according to the range of a particular indicator: from its minimal value up to the maximal value.

Chart B. Core indicator I: Credit to the private nonfinancial sector-to-GDP gap (based on the standardised Basel model)
(Q1 2001 – Q1 2022)



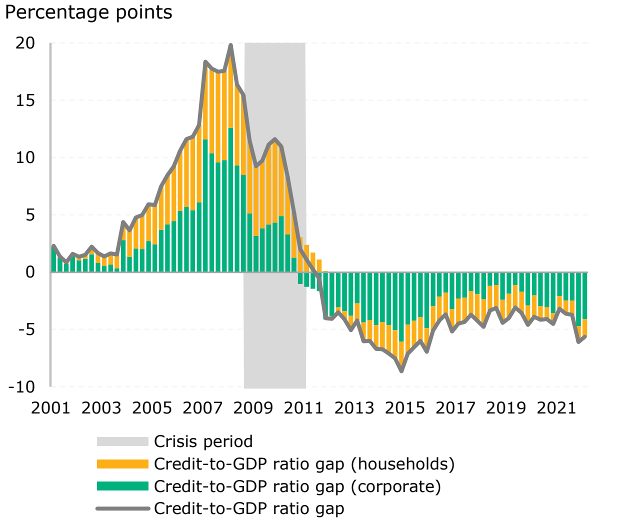
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend is computed using a one-sided HP filter with a smoothing parameter of 400,000.

Chart C. Core indicator II: Credit to the private nonfinancial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001 – Q1 2022)



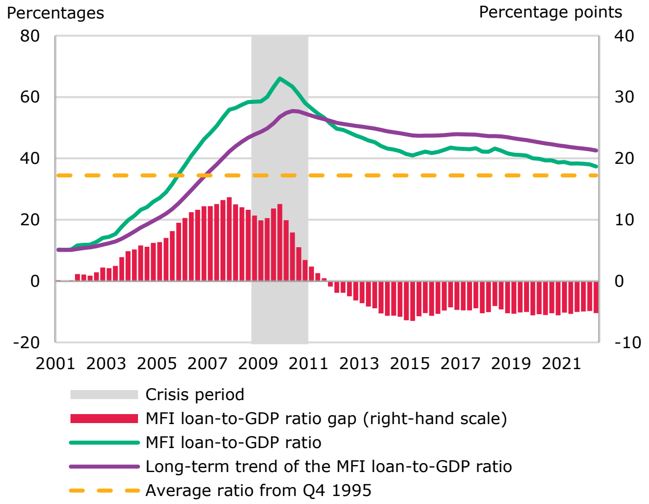
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: the long-term trend is computed by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window using a 4-quarter weighted average.

Chart D. Core indicator II: Credit to the private nonfinancial sector-to-GDP ratio gap (based on the forecast-augmented method) by sector
(Q1 2001 – Q1 2022)



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.

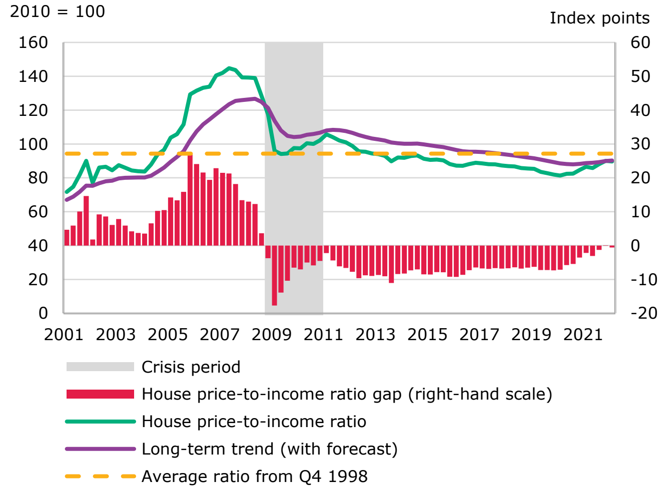
Chart E. Additional indicator I: MFI loan to the private non-financial sector-to-GDP ratio gap (based on the forecast-augmented method)
(Q1 2001 – Q2 2022)



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.

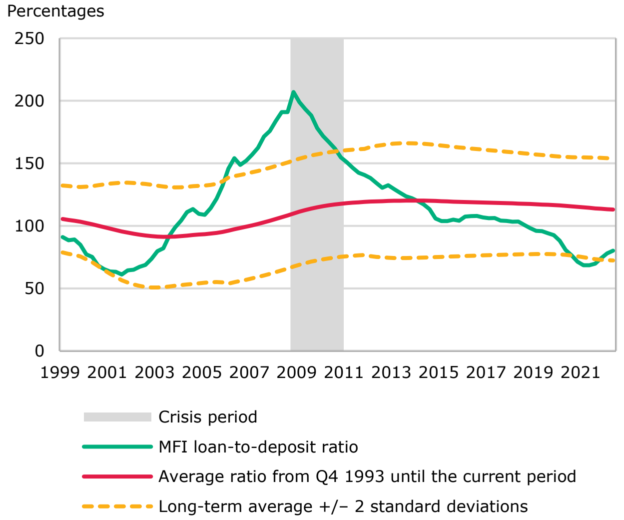
Chart F. Additional indicator II: House price-toincome ratio gap (based on the forecast-augmented method)

(Q1 2001 – Q1 2022)



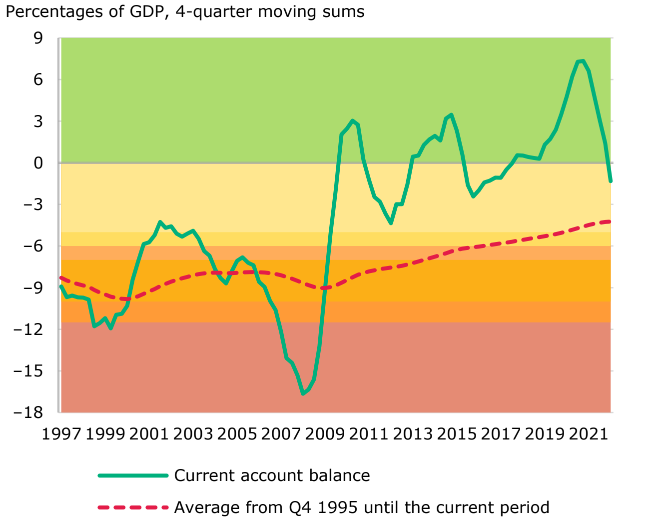
Sources: Statistics Lithuania and Bank of Lithuania calculations.
Notes: 1) income – household wages and salaries; 2) the long-term trend is estimated by applying a one-sided HP filter with a smoothing parameter of 400,000; before applying the filter, the ratio is modelled for the next 5-year window 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 2022)



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.

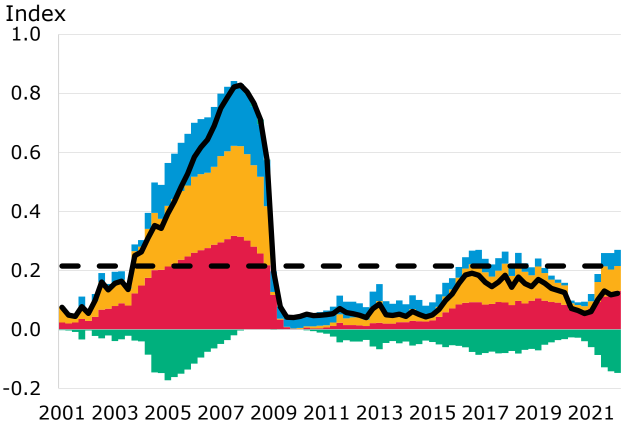
Chart H. Additional indicator IV: Ratio between the current account balance (4-quarter moving sums) and GDP
(Q1 1997 – Q1 2022)



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 – Q1 2022)



Other factors

House price-to-income ratio

Ratio between the annual change in loans to non-financial corporations and GDP

Ratio between the annual change in loans to households and GDP

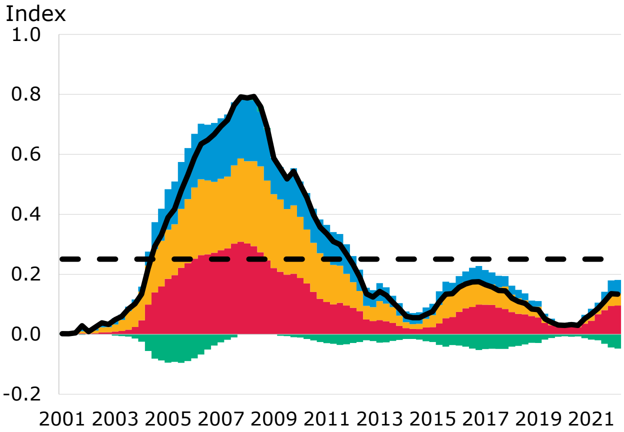
Financial cycle index

Index average (Q1 2001–Q1 2022)

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).

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

(Q1 2001 – Q1 2022)



Other factors

House price-to-income ratio

New loans to non-financial corporations and GDP ratio

New loans to households and GDP ratio

Financial cycle index

Index average (Q1 2001-Q1 2022)

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).