

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q1 2023)

The assessment of Eesti Pank in February 2023 is that risks coming from the credit cycle have increased in Estonia because of the fast growth in credit over the past year and a half. To mitigate those risks, Eesti Pank raised the countercyclical capital buffer requirement to 1.5% in November 2022. Slower credit growth now means that Eesti Pank does not consider it currently necessary to raise the countercyclical capital buffer requirement any further.

The applicable countercyclical capital buffer rate: **1%** and **1.5%** from 1 December 2023

The standardised credit-to-GDP ratio: **109%**; its deviation from the long-term trend: **-11 percentage points**.

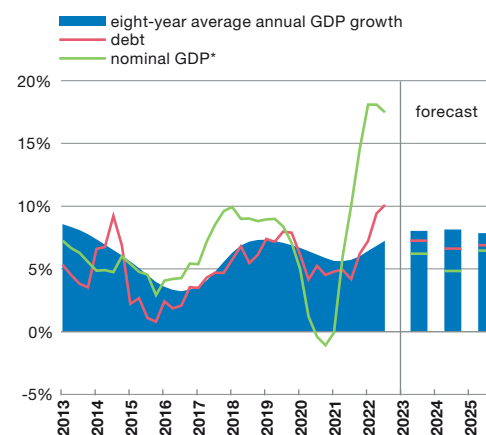
The buffer guide: **0%**

The reasoning for the buffer rate. The yearly rate of growth in the debt of the non-financial sector increased to 10% by the end of the third quarter of 2022, which is faster than the long-term nominal growth of 6-7% in the economy. Despite the rapid growth in debt in the non-financial sector, indebtedness shown by the debt-to-GDP ratio has declined consistently since high inflation has increased the nominal size of GDP. However, the December 2022 forecast from Eesti Pank shows indebtedness increasing in the coming years. Faster growth in debt than in the economy means that the risks from the financial cycle have increased and the non-financial sector will have to cope with an increased loan burden. If the macroeconomic circumstances should unexpectedly and sharply deteriorate, there could be problems in repaying loans that could be made worse by the earlier rapid growth in borrowing. It has consequently been necessary to raise the countercyclical capital buffer to ensure that the banks have large capital reserves to cover the accumulated risks. As the growth in bank loans slowed in the final months of last year, the danger of cyclical risks building up further has been eased somewhat. In consequence, Eesti Pank does not currently consider it necessary to raise the countercyclical buffer rate above 1.5%.

The yearly rate of growth in the debt of the non-financial sector continued to accelerate in the third quarter of 2022.

The debt of the non-financial sector was up 10% over the year in the third quarter, which is the fastest growth seen for eight years. The yearly rate of growth in debt was however still slower than that in nominal GDP. Inflation has made nominal GDP very volatile, and so it is reasonable to compare the growth in debt not only to current economic growth, but also to long-term economic growth. In assessing the countercyclical capital buffer requirement, Eesti Pank uses average nominal GDP growth over the past eight years as long-term GDP growth, which helps smooth the short-term volatility in the rate of growth. Data from the financial account show that the growth in debt in Estonia has exceeded the long-term nominal growth in GDP of 6-7% for four consecutive quarters, which indicates an increase in the risks coming from the financial cycle (see Figure 1). The Eesti Pank December forecast expects moving forward that the growth in debt will be relatively fast in the next three years and will exceed the growth in nominal GDP, keeping the risks in the financial

Figure 1. Forecast for annual growth of non-financial sector debt and nominal GDP



* Four-quarter moving average yearly GDP growth
Sources: Eesti Pank, Statistics Estonia

cycle (see Figure 1). The Eesti Pank December forecast expects moving forward that the growth in debt will be relatively fast in the next three years and will exceed the growth in nominal GDP, keeping the risks in the financial

sector at a higher level than before. The recovery from the pandemic in the second half of 2021 and high inflation in 2022 accelerated the current nominal growth in the economy substantially, and that will then cause a technical rise in the figure for long-term nominal GDP growth in the coming years. During this time the traditional indicator of the change in indebtedness may be a more reliable indicator for assessing the financial cycle.

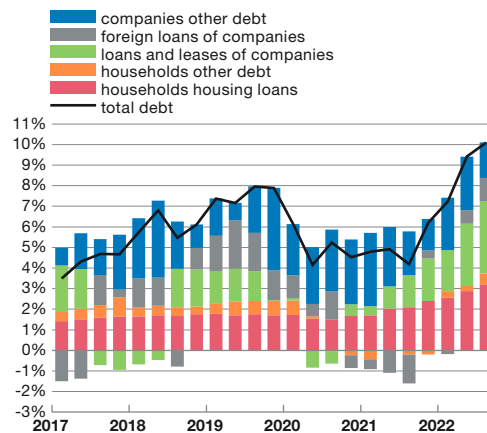
Both corporate and household debt have grown fast as corporate debt was 10% larger in the third quarter than a year earlier, and household debt was 11% larger. The growth in corporate bank loans and in housing loans to households was even faster, as it exceeded 12%, and both contributed equally to the growth in non-financial sector debt (see Figure 2).

Despite the rapid growth in debt, the indebtedness of the non-financial sector continued to decline in the third quarter of 2022. Strong nominal growth in the economy has helped the Estonian non-financial sector reduce its debt burden. Indebtedness came down to 109% by the end of the third quarter of 2022. It is still expected looking forward though that the slower growth in nominal GDP will see indebtedness stop declining and that it will start to increase again in the coming years.

Borrowing activity was reduced in the final quarter of 2022 because of uncertainty and the poorer outlook for the economy. Banking statistics show that the yearly growth in the portfolio of bank lending fell to 11% in the fourth quarter (see Figure 3), which is still relatively fast though. The rate of growth fell in the portfolios for housing loans and for corporate loans. The change in activity in the credit market is reflected most directly in new bank loans issued. The yearly growth in the volume of housing loans issued fell to -13.2% in the fourth quarter, while the growth in long-term corporate loans was down to 2.7%.

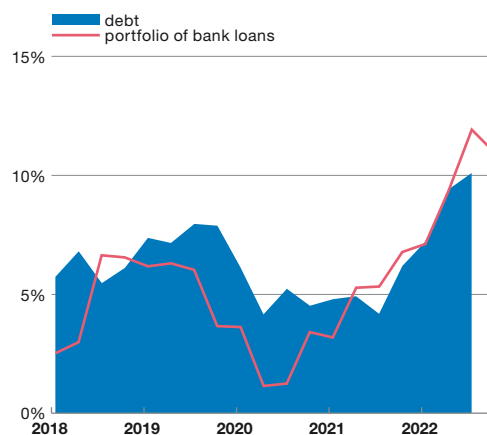
The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -11 percentage points at the end of the second quarter of 2022. The additional gap, which is also used by Eesti Pank, was -16 percentage points. The negative credit-to-GDP gap means that the credit-to-GDP ratio found with this methodology is currently lower than the long-term trend, and so the buffer guide is at 0%. The Eesti Pank

Figure 2. Contributions to yearly growth in the debt of the non-financial sector



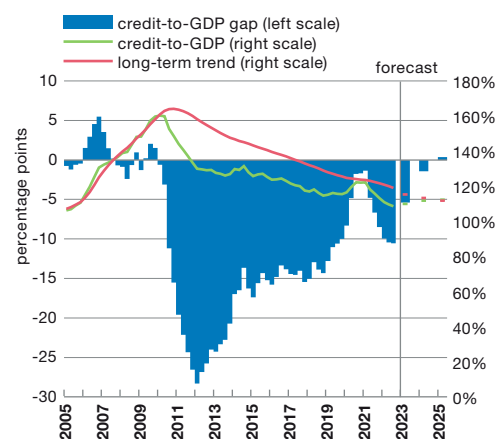
Source: Eesti Pank

Figure 3. Annual growth of non-financial sector debt and bank loans



Source: Eesti Pank

Figure 4. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

December forecast predicts that moving forward the credit-to-GDP gap will gradually narrow over the coming three years, and will become positive by the end of 2025 (see Figure 4) .

The assessment of Eesti Pank in February 2023 is that risks coming from the credit cycle have increased in Estonia because of the fast growth in credit over the past year and a half, and Eesti Pank raised the countercyclical capital buffer rate in November 2022 in response to those risks. As credit growth has slowed, Eesti Pank does not currently consider it necessary to raise the countercyclical buffer requirement further.

The rapid growth in nominal GDP caused by high inflation has led the indebtedness of the non-financial sector shown in the debt-to-GDP ratio to decline, but it is expected looking forward though that the slower growth in nominal GDP will see indebtedness stop declining and that it will start to increase again in the coming years. The growth in debt is forecast to slow in the coming years, but it will remain relatively fast, and so the current assessment is that the systemic risks coming from the financial cycle will remain in the near future.