

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q2 2023)

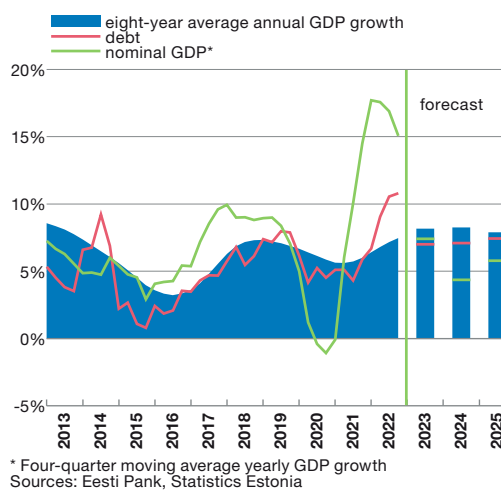
The assessment of Eesti Pank in May 2023 is that risks coming from the credit cycle are larger than before in Estonia, and Eesti Pank raised the countercyclical capital buffer rate to 1.5% in November 2022 in response to those risks. Reduced credit activity now means that Eesti Pank does not currently consider it 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: **-10 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 11% by the end of the fourth quarter of 2022, which is faster than the long-term nominal growth of 7% in the economy. Faster growth in debt than in the economy means that the risks from the financial cycle are larger than before. 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 was consequently necessary to raise the countercyclical capital buffer to ensure that the banks have large capital reserves to cover the accumulated risks. As activity in taking bank loans has been diminishing since the final months of 2022 and growth in the loan portfolios of the banks has slowed, the danger of cyclical risks building up further has been eased. 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 fourth quarter of 2022.

The debt of the non-financial sector was up 11% over the year in the fourth quarter, which is the fastest growth seen for 14 years. Both corporate and household debt liabilities have grown fast, having both increased by 11% over the year in the fourth quarter of 2022. The yearly rate of growth in debt was however still slower than that in nominal GDP. Inflation has made nominal GDP very volatile, and 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 7% for five consecutive quarters, which indicates an increase in the risks coming from the financial cycle (see Figure 1). The March economic forecast from Eesti Pank expects the debt of the non-financial sector to grow by a little under 7% this year, and by more than 7% in the next two years. This means the growth in debt will be relatively fast moving forwards, and it will start to exceed the current nominal growth in GDP next year.

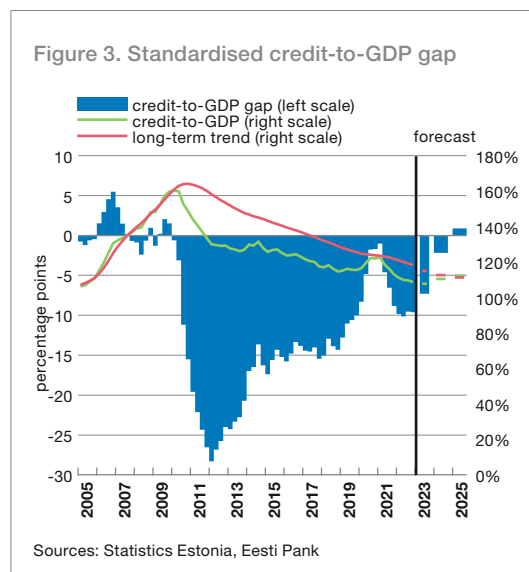
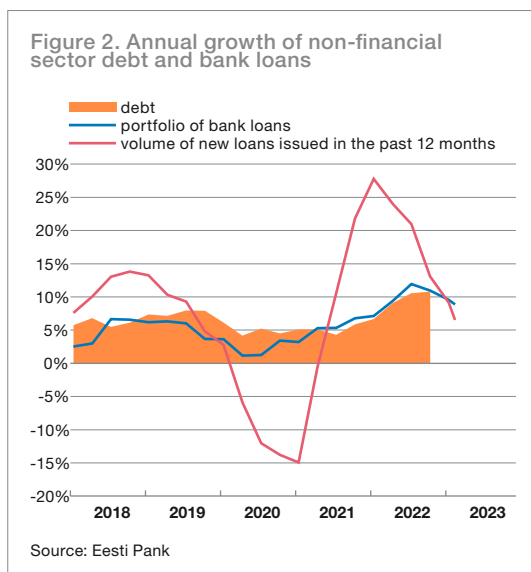
Figure 1. Forecast for annual growth of non-financial sector debt and nominal GDP



Despite the rapid growth in debt, the indebtedness of the non-financial sector continued to decline. Strong nominal growth in the economy has helped the Estonian non-financial sector reduce its debt burden. Indebtedness came down below 109% by the end of the fourth quarter of 2022. The Eesti Pank March forecast still expects looking forward though that the slower growth in nominal GDP will see indebtedness stop declining and that it will start to increase again from 2024.

Borrowing activity was weaker in the first four months of 2023 because of uncertainty and the deterioration in the outlook for the economy. Banking statistics show that companies and households took some 4% less in new loans in the first four months of the year than they did in the same months of last year. The drop in borrowing activity was larger for households, which took 9% less in new loans than a year earlier. Reduced borrowing activity is also reflected in the slower rate of yearly growth in the loan portfolio. The yearly growth in the loan portfolio of the non-financial sector fell to 9% by the end of April 2023 (see Figure 2).

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -10 percentage points at the end of the fourth quarter of 2022. The additional gap, which is also used by Eesti Pank, was -15 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 March forecast predicts that moving forward the credit-to-GDP gap will gradually start to narrow, and it will become positive again by the end of 2025 (see Figure 3).



The assessment of Eesti Pank in May 2023 is that risks coming from the credit cycle are larger than before 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 borrowing activity has declined and 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 but to remain relatively fast, and so the current assessment is that the systemic risks from the financial cycle will remain in the near term.