

# THE COUNTERCYCLICAL CAPITAL BUFFER RATE

## EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q3 2023)

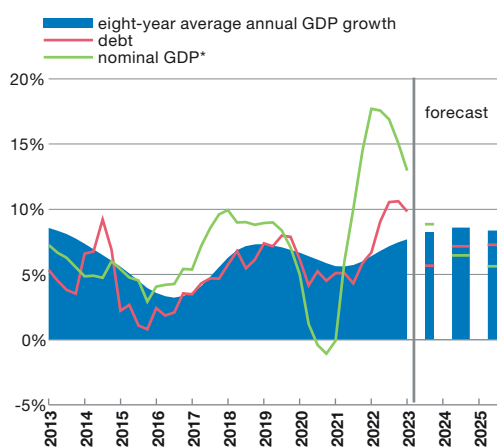
Eesti Pank decided in November 2022 to raise the countercyclical capital buffer rate to 1.5%, as rapid credit growth had increased the risks from the financial cycle. Credit activity has since declined and so Eesti Pank does not currently consider it necessary to raise the countercyclical capital buffer requirement any further.

- The applicable countercyclical capital buffer rate: **1%;** **1.5%** from 1 December 2023
- The standardised credit-to-GDP ratio: **108%;** its deviation from the long-term trend: **-9 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 was 10% at the end of the first quarter of 2023, which is faster than the long-term nominal growth in the economy. Faster growth in debt than in the economy is an indicator of risks from the financial cycle. 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. Activity in taking bank loans has been diminishing since the final months of 2022 and growth in the aggregate loan portfolio of the banks has slowed, so 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 growth in the debt of the non-financial sector slowed in the first quarter of 2023.

The debt of the non-financial sector was 10% larger in the first quarter than it was a year earlier. The rate of growth in debt slowed in the first quarter but it remained fast, and the last time it was so fast was during the credit boom 14 years ago. Both corporate and household debt liabilities have grown fast, and the rate of yearly growth in both of them was 10% in the first quarter. The yearly rate of growth in debt was however still slower than that in nominal GDP. Inflation is making 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 exceeded long-term nominal growth in GDP of 7.7% for the fifth quarter in a row, indicating that the risks coming from the financial cycle remain in Estonia (see Figure 1). The Eesti Pank June forecast expects the growth in debt to slow to 5.7% by the end of this year. As investment increases though, growth in debt will start to accelerate again, and it will remain above 7% for the next two years.

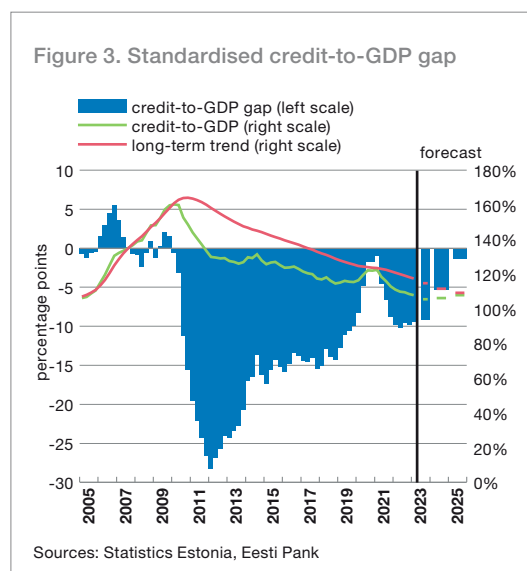
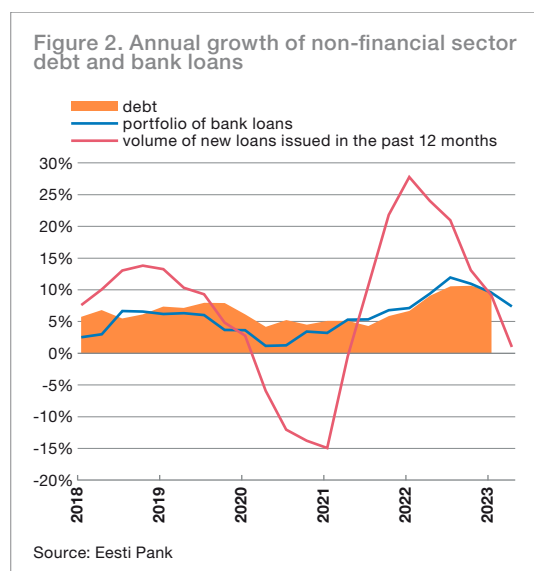
Figure 1. Forecast for annual growth of non-financial sector debt and nominal GDP



**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, and indebtedness came down to 108% by the end of the first quarter of 2023. The Eesti Pank June 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 half of 2023 because of uncertainty and the deterioration in the outlook for the economy.** Banking statistics show that companies and households took some 5% less in new loans in the first half of the year than they did in the same months of last year. The drop in borrowing activity was larger for households, which took 10% 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 7% by the end of June 2023 (see Figure 2).

**The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -9 percentage points at the end of the first quarter of 2023.** 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 June forecast predicts that moving forward the credit-to-GDP gap will gradually start to narrow, and will reach -1% by the end of 2025 (see Figure 3).



**The assessment of Eesti Pank in September 2023 is that risks coming from the credit cycle remain in Estonia because of the fast growth in credit over the past year and a half.** To reduce those risks, Eesti Pank raised the countercyclical capital buffer rate in November 2022. As borrowing activity has declined and credit growth has slowed, the danger of such risks building up further in future has eased and it is not currently necessary to raise the countercyclical buffer rate further.