

THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q4 2023)

Eesti Pank raised the countercyclical capital buffer rate to 1.5% because of the increase in risks that followed from the rapid growth in credit in the preceding year and a half. The new buffer rate started to apply from 1 December 2023. Credit activity has since declined and the systemic risks coming from the financial cycle have stopped accumulating, and so Eesti Pank does not currently consider it necessary to raise the countercyclical capital buffer requirement any further.

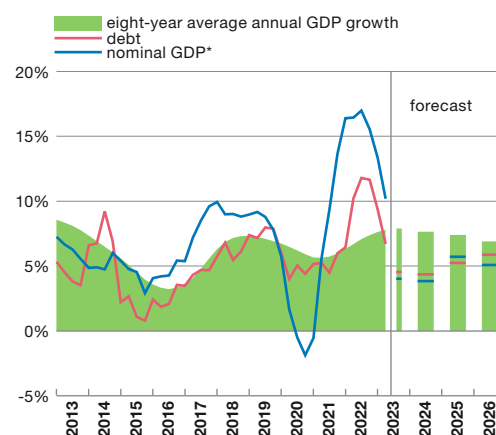
- The applicable countercyclical capital buffer rate: **1.5%**
- The standardised credit-to-GDP ratio: **108%**; its deviation from the long-term trend: **-8 percentage points**
- The buffer guide: **0%**
- **The reasoning for the buffer rate.** The yearly rate of growth in the debt of the non-financial sector was almost 7% at the end of the second quarter of 2023. The growth in debt has started to slow and is now below both the long-term rate of growth in the economy and the current nominal rate, but the rapid growth in credit in the preceding year and a half meant that there are still reasons to consider that the risks from the financial cycle remain present in Estonia. If the macroeconomic circumstances should unexpectedly and sharply deteriorate, there could be larger problems in repaying loans. It was consequently necessary to raise the countercyclical capital buffer to ensure that the banks have large capital reserves to cover the accumulated risks. Eesti Pank does not consider it currently necessary to raise the buffer rate any further.

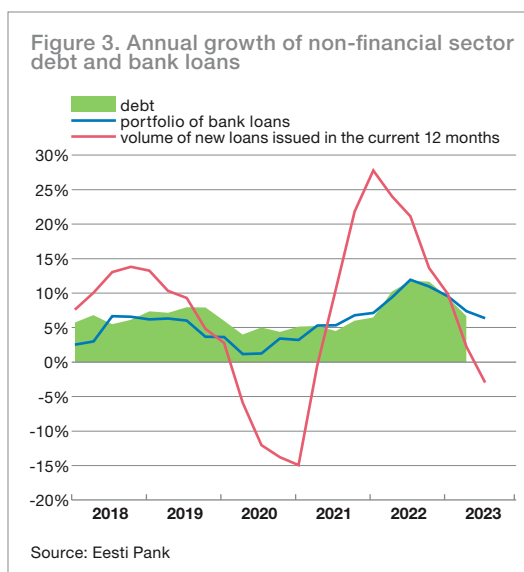
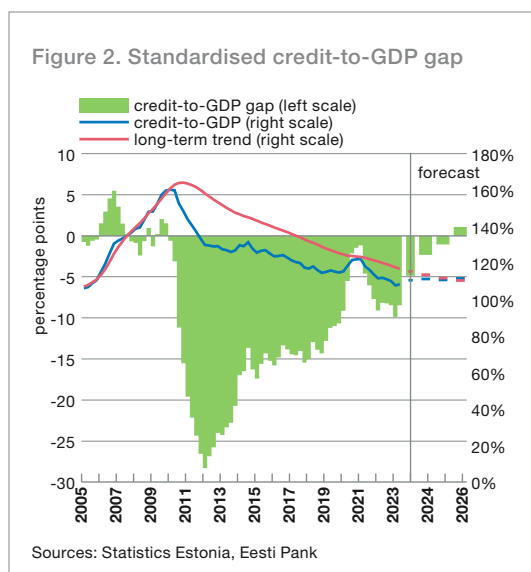
The yearly growth in the debt of the non-financial sector slowed in the second quarter of 2023.

The yearly growth in the debt of the non-financial sector was 6.7% in the second quarter, which was a slower rate than the growth in 12-month 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 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 debt in the second quarter of 2023 growing in Estonia at below the 7.8% recorded by eight-year average growth in nominal GDP, indicating that the risks from the financial sector have stopped accumulating in Estonia. The Eesti Pank December forecast expects growth in debt to slow to 4.5% by the end of this year and remain at the same level next year, after which it will pick up again as investment increases and it will reach 6% by the end of 2026 (see Figure 1).

As growth in the economy has slowed, the debt burden shown by the debt-to-GDP ratio has stopped falling. High inflation meant that nominal GDP grew faster than the non-financial sector's debt until the end of the first quarter of this year, causing the debt burden to decline, but quarterly growth

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





in current 12-month nominal GDP slowed in the second quarter of 2023 enough that the debt burden stopped shrinking. The debt burden is forecast to remain relatively stable in the next two years (see Figure 2).

Borrowing activity has been declining since 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 7% less in new loans in the second quarter and 6% less in the third than they did in the same quarters of last year. The drop in borrowing activity was larger for households, which took 14% less in new loans in the third quarter than they did 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 6% by the end of October 2023 (see Figure 3).

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -8 percentage points at the end of the second quarter of 2023. The additional gap, which is also used by Eesti Pank, was -12 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 December forecast predicts that moving forward the credit-to-GDP gap will gradually start to narrow, and will become positive by the end of 2026.

The assessment of Eesti Pank in December 2023 is that although the growth in debt has slowed, the risks coming from the credit cycle remain high in Estonia because of the fast growth in credit over the preceding year and a half. To reduce those risks, Eesti Pank raised the countercyclical capital buffer rate in November 2022. The higher requirement started to apply from 1 December 2023. As borrowing activity has by now shown signs of declining and credit growth has slowed, the danger of cyclical risks building up further in future has eased and it is not currently necessary to raise the countercyclical buffer rate further.