THE COUNTERCYCLICAL CAPITAL BUFFER RATE

EESTI PANK'S ASSESSMENT OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE (Q2 2024)

Eesti Pank raised the countercyclical capital buffer rate to 1.5% because of the risks that followed from the rapid growth in credit in 2021-2022. The new rate started to apply from 1 December 2023. Although borrowing has now eased off in Estonia, it is still necessary to maintain the buffers to protect against the risks that accumulated earlier.

The applicable countercyclical capital buffer rate: **1.5%**

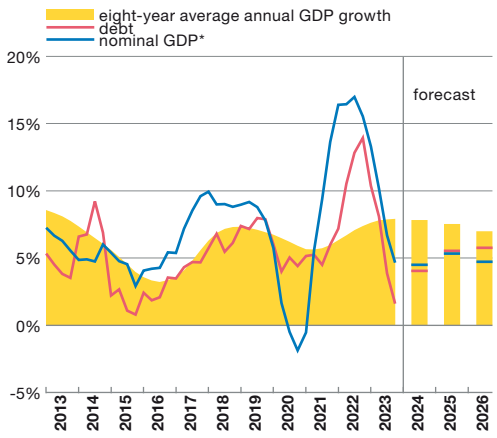
The standardised credit-to-GDP ratio: **109%**; its deviation from the long-term trend: **–7 percentage points**

The buffer guide: **0%**

The reasoning for the buffer rate. The danger of cyclical risks building up further in future has eased. The yearly rate of growth in the debt of the non-financial sector slowed to 1.6% by the end of the fourth quarter of 2023, and it is now below both the long-term rate of growth in the economy and the current nominal rate. The risks from the rapid growth in credit in 2021-2022 still remain in Estonia though, and it is reasonable for the banks to continue to hold a countercyclical capital buffer of 1.5% to cover those risks.

The yearly rate of growth in the debt of the non-financial sector continued to decelerate in the fourth quarter of 2023. Yearly growth in the debt of the non-financial sector was 1.6% in the fourth quarter of 2023, which was a slower rate than that of nominal GDP growth for the current 12 months, and than long-term[1] nominal growth. Growth in debt has fallen for four consecutive quarters and remained slower than that in long-term nominal GDP in the second half of 2023, which indicates that the risks coming from the financial cycle have stopped accumulating in Estonia. The March economic forecast from Eesti Pank expects the rate of growth in debt to pick up again this year, though it will remain more modest than it has been in recent years. Debt will grow more slowly this year than nominal GDP, but in the next two years the growth in debt will start to exceed that in the economy (see Figure 1).

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



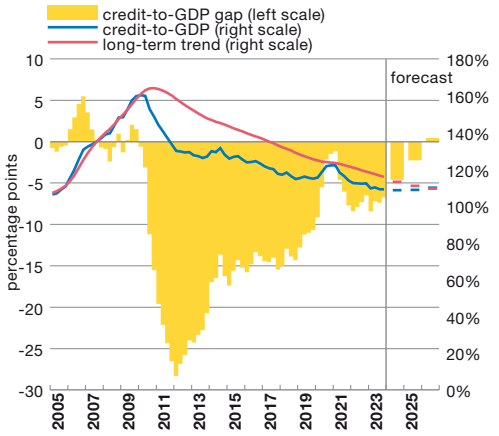
* Four-quarter moving average yearly GDP growth
Sources: Eesti Pank, Statistics Estonia

As economic activity has faded, so indebtedness, or the debt-to-GDP ratio, has fallen further. The indebtedness of the non-financial sector fell to 109% by the end of 2023 (see Figure 2). It is forecast to remain at the same level in the coming years, as debt will grow at more or less the same rate as the economy.

Borrowing activity has declined since the first half of 2023 because of the high levels of uncertainty and the worse outlook for the economy. Banking statistics show that companies and households took some 5% less in new loans in the fourth quarter of 2023 and 1% less in the first quarter

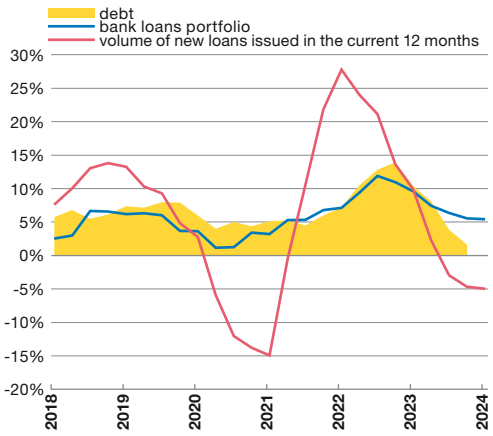
1 In assessing the countercyclical capital buffer requirement, Eesti Pank uses average nominal GDP growth over the past eight years as long-term GDP growth, which helps smooth the short-term volatility in the rate of growth.

Figure 2. Standardised credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank

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



Source: Eesti Pank.

of 2024 than they did in the same quarters of the preceding years. Reduced borrowing activity is also evident 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 5.4% by the end of March 2024 (see Figure 3).

The standardised credit-to-GDP gap calculated using the methodology of the Basel Committee on Banking Supervision was -7 percentage points at the end of the fourth quarter of 2023. The additional gap, which is also used by Eesti Pank, was -10 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 start to narrow gradually, and will become positive by the end of 2026.

In summary, the estimate of Eesti Pank in June 2024 is that the danger of cyclical risks accumulating further has eased. The rate of growth in debt is expected to increase moving forwards, but it will still remain moderate. The risks from the rapid growth in credit in 2021-2022 still remain in Estonia though, and it is reasonable for the banks to continue to hold a countercyclical capital buffer of 1.5% to cover those risks.