COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

30 DEC. 2022

Pursuant to the decision of the Board of Directors of 20 December 2022, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 January 2023

Recent developments indicate that the war in Ukraine will continue, which might prolong the existing inflationary pressures. This scenario combined with the increase of interest rates and worsened economic sentiment, heightens uncertainty about future economic developments. However, despite financial and geopolitical risks, the economic activity is still expected to grow, although at a toned-down pace.

This decision was taken given the abovementioned information and the assessment of a set of financial and macroeconomic indicators.[1]

Both credit-to-GDP measures remain below their long-term trends

In the second quarter of 2022, both the Basel gap and the additional credit-to-GDP gap remained negative and significantly below the threshold that would trigger a positive benchmark buffer rate (2 p.p.) (Chart 1). The Basel gap reached -29.8 percentage points (p.p.) (-27.1 p.p. in the previous quarter), driven by the credit-to-GDP ratio decrease. The additional credit-to-GDP gap increased slightly during the same period, reaching -11.2 p.p. (-11.4 p.p. in the previous quarter).

The credit-to-GDP ratio was 161.5% in the second quarter of 2022 (165.9% in the first quarter of 2022), maintaining the downward trajectory observed in previous quarters. The total credit granted[2] to the private non-financial sector increased 2.4% (year-on-year) in the same quarter, driven by an increase in total credit granted to non-financial corporations (NFCs) and to households (1.7% and 3.3%, year-on-year, respectively). Nominal GDP increased significantly (10.0%, year-on-year), and at a higher rate than the outstanding total credit to the private non-financial sector, which explains the decrease in the credit-to-GDP ratio. This represents a correction from the evolution displayed in 2020, when declining nominal GDP was the main driver behind an increase in the credit-to-GDP ratio, reinforcing the numerator effect promoted by total credit growth. More recently, in August 2022, the annual rate of change of the total credit granted to the private non-financial sector adjusted for securitisation operations, reclassifications, sales, write-offs and price and exchange rate revaluations was 3.1% (year-on-year), driven by an increase in total credit granted to NFCs and to households (2.5% and 3.9%, respectively).

The projections published in the October 2022 *Economic Bulletin* of Banco de Portugal revised upwards the projected GDP growth for 2022 (from 6.3%, in June 2022, to 6.7%)[3], reflecting both the tourism and the private consumption recovery. The

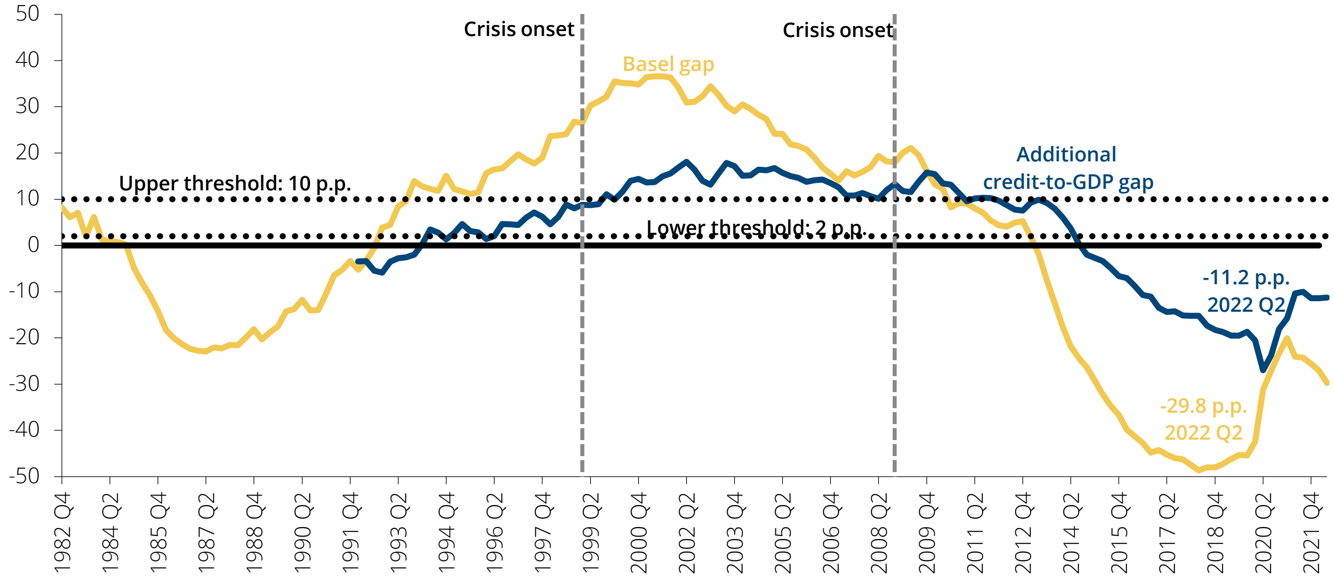
[1] The assessment is based on data available up to 31 October 2022. Any differences in figures from previous assessments are due to revisions in underlying data.

[2] Total credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector.

[3] The October 2022 Economic Bulletin of the Banco de Portugal is available at the Banco de Portugal website.

downside risks are associated with the deterioration of the international environment, resulting from the war in Ukraine, and reflected on higher and more persistent inflation rates, lower energy supply and reduced confidence of the economic agents. Considering the projections for GDP growth published in the June 2022 *Economic Bulletin* as well as the expectations of a decrease in credit demand and tighter credit standards practised by banks for the next quarter (October 2022 *Banking Lending Survey*), the sign of both credit-to-GDP measures is unlikely to change in the short term.

Chart 1 • Basel gap and additional credit-to-GDP gap[4] | In percentage points



Sources: Banco de Portugal and Statistics Portugal. | Notes: The last observation refers to 2022 Q2, p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The adjusted[5] bank credit to the non-financial private sector, in nominal terms, has remained relatively stable

Outstanding real bank credit to the non-financial private sector continued to decline in the third quarter of 2022 (-5.6%, year-on-year), due to the decrease in outstanding real total credit to both NFCs and households (-6.7% and -4.7%, respectively) (Chart 2). Concerning households, the year-on-year decrease in outstanding real bank credit reflects a decrease of both credit for house purchase (-4.6%) and credit for consumption and other purposes (-5.3%). These developments reflect the surge of inflation (9.1%, year-on-year, in the third quarter of 2022), as bank credit to NFCs and households continued to increase in nominal terms (1.8% and 3.9%, respectively).

The annual rate of change of the outstanding nominal bank credit to the non-financial private sector adjusted for securitisation operations, reclassifications, sales, write-offs and price and exchange rate revaluations was positive in August 2022 (2.5%) (in real terms, the adjusted annual rate of change was -6.4%). This evolution was driven by the increase in the adjusted annual rate of change of outstanding nominal bank credit to NFCs (0.4%) (in real terms, the adjusted annual rate of change was -8.5%) and in the outstanding nominal bank credit to households (4.0%) (in real terms, the adjusted annual rate of change was -5.0%). Regarding households, the adjusted annual rate of change reached 4.2% and 3.2% for house purchase and for consumption and other purposes, respectively (in real terms, the adjusted annual rates of change were -4.7% and -5.7%, respectively).

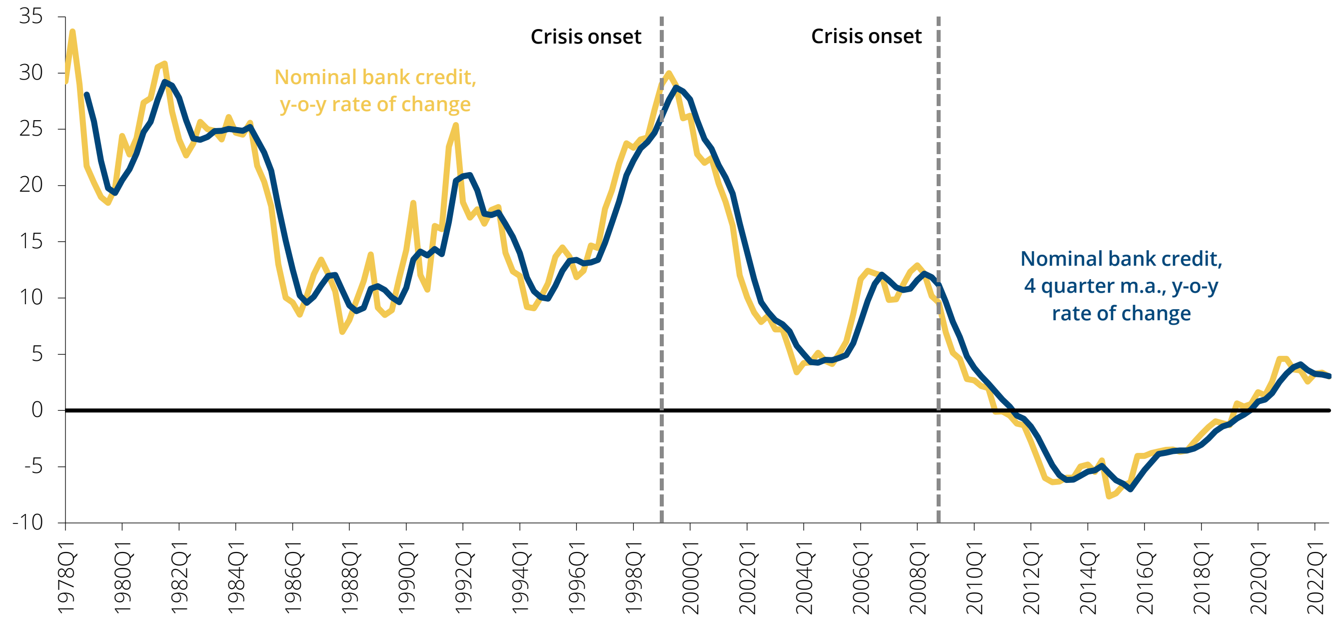
[4] The credit-to-GDP gap is calculated as the percentage point difference between the observed credit-to-GDP ratio and its long-term trend, where the trend is estimated employing a one-sided HP filter with a smoothing parameter set to 400,000. The additional credit-to-GDP gap is computed as the percentage point difference between the observed credit-to-GDP ratio augmented with ARIMA(p,1,0) forecasts, using a maximum forecast horizon of 28 quarters, and its long-term trend, where the trend is estimated employing a one-sided Hodrick-Prescott filter with a smoothing parameter set to 400,000. Until the first quarter of 2015, the optimal lag order (p) of the forecasting model is recursively determined. From the second quarter of 2015 onwards, p is set to three quarters, which is the optimal lag length when data until the first quarter of 2015 is used. In case the gap exceeds 2 p.p., the benchmark buffer rate will increase linearly from 0% to the upper threshold of 2.5% of the total risk exposure amount, which is associated with a gap of 10 p.p. See Recommendation ESRB/2014/1 Annex Part II available at the ESRB website. Basel Committee on Banking Supervision thresholds of 2 p.p. and 10 p.p. were determined using the Basel gap. Nevertheless, they are used as an approximation to map the additional credit-to-GDP gap into a benchmark buffer rate.

[5] Adjusted for securitisation operations, reclassifications, sales, write-offs, price, and exchange rate revaluations.

As to financing conditions, in September 2022 the average interest rate on new lending to NFCs reached 3.0%, increasing by 0.9 p.p. when compared to June 2022. Concerning households, the average interest rate on new lending for house purchase reached 2.2% in September 2022, increasing by 0.8 p.p. when compared to June 2022. The average Interest rate on new lending for consumption and other purposes was 6.5%, in September 2022, also above the values reported in June 2022 (6.2%). The increase in the average interest rates follows the increase of Euribor rates, associated with the context of tighter monetary policy, since spreads have in fact decreased. This trajectory is likely to continue since, according to the October 2022 ECB's monetary policy statement, interest rates are expected to increase further, because inflation remains high and is likely to stay above target for an extended period.[6]

Looking forward, according to the October 2022 *Bank Lending Survey*[7], over the fourth quarter of 2022, credit standards are expected to become tighter for NFCs (especially for SMEs and long-term loans) and somewhat tighter for households. The demand for loans by NFCs is expected to decrease, especially in the case of large firms and in long-term loans, as the demand for short-term loans is expected to slightly increase. A decrease in the demand for loans by households is also expected, more pronounced in the housing segment.

Chart 2 • Year-on-year rate of change of nominal bank credit[8] | Per cent



Sources: Banco de Portugal and Statistics Portugal. | Notes: The last observation refers to 2022 Q3, m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The growth rate of residential real estate prices remains robust

In the second quarter of 2022, the nominal house price index increased by 13.2% (year-on-year), comparing with year-on-year growth rates of 12.9% and 11.6% in the first quarter of 2022 and in the fourth quarter of 2021, respectively. In real terms, the house price index continued to increase, attaining a growth rate of 6.8% (year-on-year), although slowing down since the third quarter of 2021 (Chart 3).

In this period, the growth of house transactions significantly decelerated, with a year-on-year rate of change of 4.5%, which compares with a rate of change of 25.8% in the first quarter of 2022. On the supply side, in the second quarter of 2022, building permits for new constructions and completed buildings in Portugal decreased by 6.7% and 4.9% (year-on-year), respectively[9].

[6] More information is available at the European Central Bank website.

[7] More information is available at the Banco de Portugal website.

[8] Bank credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector and held by banks. Bank credit granted by resident monetary financial institutions as available in Monetary and Financial Statistics published by the Banco de Portugal.

[9] More information is available at the Statistics Portugal website.

The average value per house transaction continued to increase, attaining a 14% growth rate year-on-year, in line with the last two quarters.

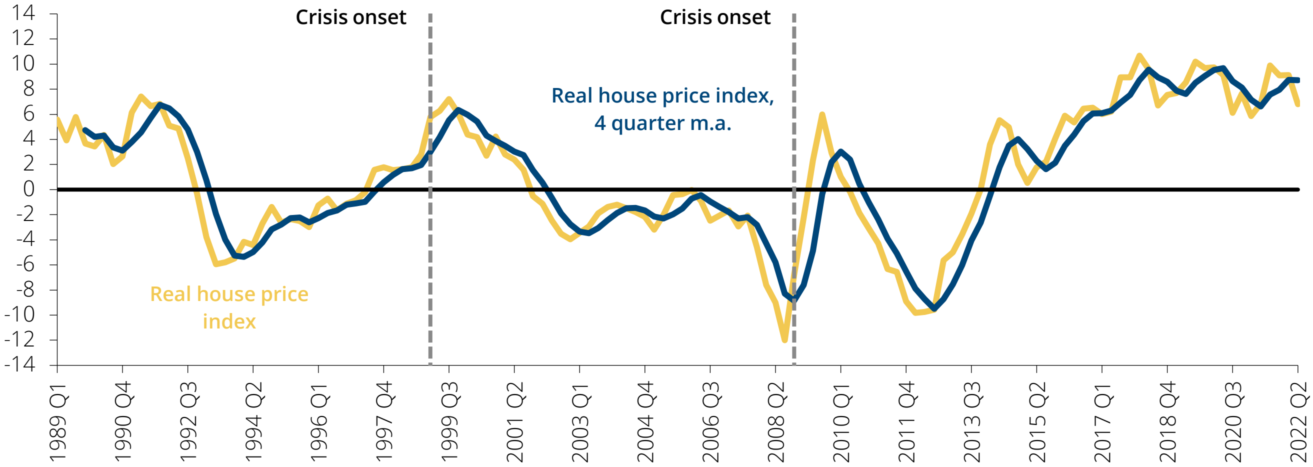
The August 2022 Portuguese Housing Market Survey[10] suggests an ongoing softening of the residential real estate market activity, with declining buyer demand, and agreed sales, but with prices currently remaining strong due to insufficient supply. For the future, the majority of survey participants expects near-term sales to plateau and prices to increase across all geographical areas at a three-month time horizon, although a slowdown is expected. Prices are predicted to exhibit the same subdued upward trajectory in the year ahead. Additionally, survey respondents' expectations on the rental market indicate a more resilient behavior when compared to the sales market, despite moderate slowdowns in the pace of tenant demand and rental growth.

The September 2022 Portuguese Investment Property Survey[11] reflects a subdued prospective market behavior associated to the current overall macroeconomic context. Moreover, developers point to a 19% construction cost upsurge, which is anticipated to crowd out national demand due to its pressure on prices. Nevertheless, real estate promoters seem to assume that this market situation is temporary, remaining optimistic regarding the launch of new projects and demand for new land for development in the future.

The August 2022 Survey on Bank appraisal on housing[12] indicates that the median value of bank appraisals increased 15.8% (year-on-year) in August 2022 (16.1% year-on-year in the previous month). The number of bank appraisals diminished for the third consecutive month (-10.4%, year-on-year) in August 2022, compared to a decline rate of 6% year-on-year in the previous month.

All in all, a context of high inflation, potential declining real disposable income and rising financing costs stemming from tighter monetary policy may lead to a reduction in demand for residential real estate, notably by residents, thus potentially contributing to a slowdown in residential real estate prices.

Chart 3 • Year-on-year rate of change of house prices, in real terms[13] | Per cent



Source: Organization for Economic Co-operation and Development. | Notes: The last observation refers to 2022 Q2, m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The composite indicator of financial stress for Portugal declined, signalling a favourable evolution, but the economic sentiment indicator dropped further, thus continuing below pre-pandemic values

[10] The *Portuguese Housing Market Survey (PHMS)*, a joint initiative by Confidencial Imobiliário and the Royal Institution of Chartered Surveyors, provides a qualitative assessment of the sales and lettings markets, based on a monthly survey to a panel of real estate agents and developers.

[11] The Portuguese Investment Property Survey (PIPS), an initative by Confidencial Imobiliário supported by Associação Portuguesa dos Promotores e Investidores Imobiliários, analyses sentiment and perception of real estate developers and investors in order to anticipate the market cycle, on a quarterly basis.

[12] More information is available at the Statistics Portugal website.

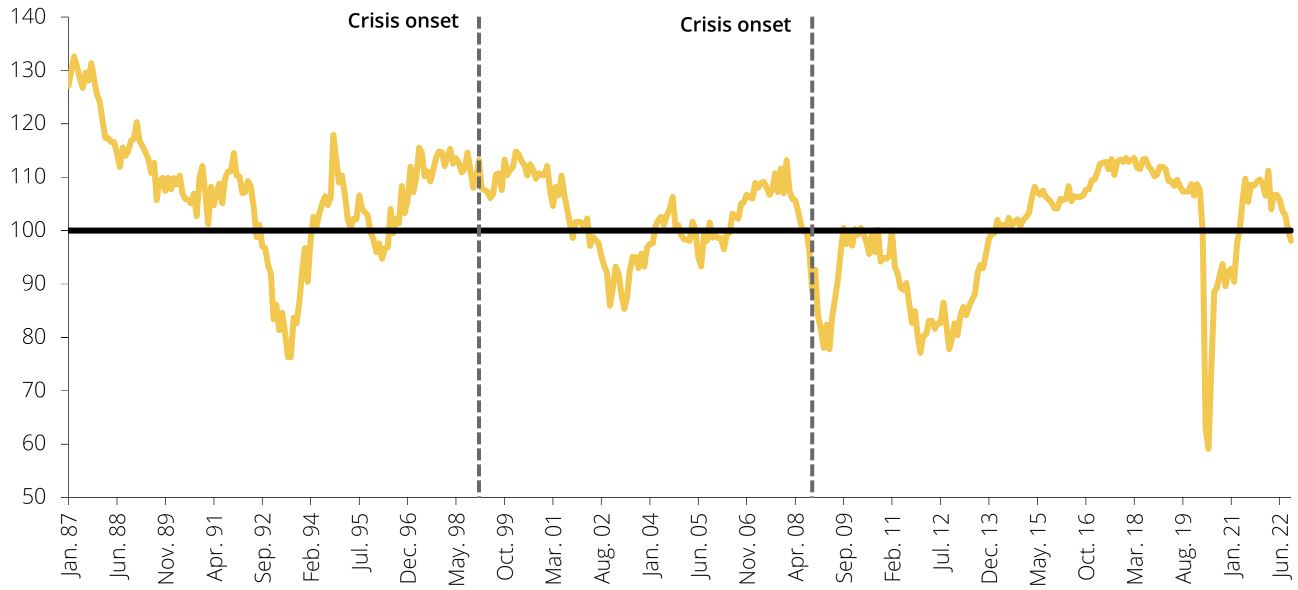
[13] Real house price index (2015=100) published by the Organization for Economic Co-operation and Development. The house price index is adjusted for inflation using the private consumption deflator (2016=100) taken from the National Accounts (ESA2010, base 2016) published by Statistics Portugal.

In September 2022, the downward trajectory of the composite indicator of financial stress for Portugal, observed since the previous month, was reinforced. Financial stress moderately subsided in Portugal, despite the expected economic activity slowdown (as reflected in the IMF's October 2022 World Economic Outlook), the persistent inflationary dynamic, the spillovers from the war in Ukraine, the lockdown policy in China, and the monetary tightening enacted by central banks across the world.

The tightening of monetary policy may contribute to accelerate the correction of imbalances built-up in the past and to mitigate search-for-yield behavior in international financial markets. Nevertheless, given the high level of uncertainty currently faced, the evolution of this indicator should be followed very closely.

The economic sentiment indicator for Portugal continued to follow the decreasing path initiated in April 2022, thus remaining below pre-pandemic levels. This negative evolution was mainly motivated by a deterioration in consumer confidence. Only the services confidence indicator showed a positive trend, although at a lower rate than in the previous months, signalling the degradation of the overall index.

Chart 4 • Economic Sentiment Indicator for Portugal | Index (2000-2022 average = 100)



Source: European Commission. | Notes: The last observation refers to October 2022. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

General assessment

Taking into account all available information and in line with previous risk assessments, Banco de Portugal decided not to change its macroprudential policy stance regarding the countercyclical capital buffer, maintaining its rate at 0% of the total risk exposure amount over the first quarter of 2023.

In the context of monetary policy normalization, high inflation and economic slowdown, the room for further accumulation of cyclical systemic risk should be limited. Nevertheless, Banco de Portugal will continue to closely monitor its developments and may adopt further macroprudential measures aimed at mitigating the potential build-up of systemic risk in the economy.