COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

31 MAR. 2022

Pursuant to the decision of the Board of Directors of 29 March 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 April 2022

In the aftermath of the pandemic, a stronger than anticipated recovery in economic activity contributed to the mitigation of near-term risks to financial stability. However, the temporary effects of the adjustment of a high demand and a conditioned supply interrupted the recovery's pace. In addition, the current Russia-Ukraine conflict as well as the financial and trade sanctions led to higher energy and raw material prices, disrupted trade interlinkages and supply chains, which affected the economic outcome. The outlook in the medium term remains constrained by uncertainty surrounding the evolution of the pandemic and the Russia-Ukraine conflict, challenging economic growth and inflation.

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

Both measures of the credit-to-GDP gap remain at negative levels

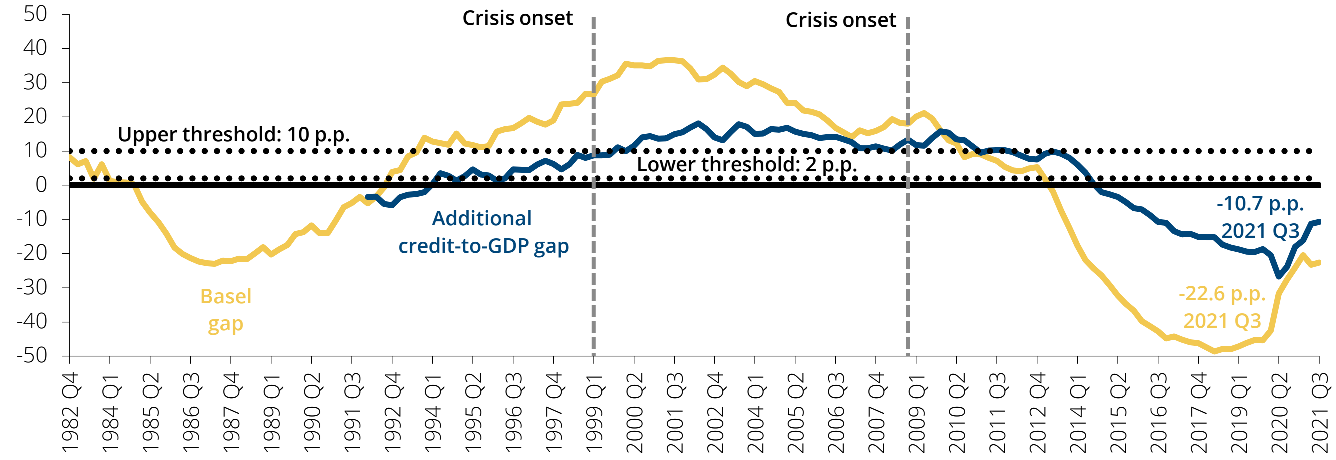
In the third quarter of 2021, the Basel gap increased slightly from -23.3 to -22.6 percentage points (p.p.), as the decline of the credit-to-GDP ratio was approximately half of the increase of its long-term trend. The additional credit-to-GDP gap also became slightly less negative, reaching -10.7 p.p. (Chart 1). Both measures show that the credit-to-GDP ratio remains well below long-term trends and, therefore, the threshold that would trigger a positive benchmark buffer rate (2 p.p.) was not reached.

The credit-to-GDP ratio decreased from 174.2% to 173.5%, from the second to the third quarter of 2021. From the first quarter of 2021 onwards, nominal output has increased at a higher rate than total credit outstanding to the private non-financial sector (quarter-on-quarter), leading to this recent downward trajectory of the credit-to-GDP ratio. In the third quarter of 2021, total credit granted[2] to the private non-financial sector increased 2% (year-on-year), driven by an increase in both credit granted to non-financial corporations (NFCs) (1.1%, year-on-year) and to households (3.5%, year-on-year). The annual rate of change adjusted for securitisation operations, reclassifications, write-offs, price and exchange rate revaluations, and sales, of the credit granted to the non-financial private sector, in November 2021, was 2.8% (year-on-year), driven by an increase in both credit granted to NFCs and to households (2.6% and 3.3%, respectively). As such, the decrease in the credit-to-GDP ratio was mainly driven by the large increase in nominal GDP (4.9%, year-on-year), which outweighed the increase in credit.

[1] The assessment is based on data available up to 2 February 2022. Any differences in figures from previous assessments are due to revisions in underlying data.

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

Chart 1 • Basel gap and additional credit-to-GDP gap[3] | In percentage points



Sources: Banco de Portugal and Statistics Portugal. | Notes: The last observation refers to 2021 Q3. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Following a fall in GDP in 2020 (-8.4%), the Portuguese economy grew by 4.9% in 2021 (INE's estimate).[4] According to the March 2022 Banco de Portugal's *Economic Bulletin*, GDP is expected to continue recovering in 2022 (4.9%), showing a more moderate pace of expansion in 2023 and 2024 (2.9% and 2.0% respectively). GDP is expected to return to its pre-pandemic level in the first half of 2022. In the short term, the predominant downside risk is associated with a further worsening of the pandemic situation with an impact on economic agents' confidence and activity. The persistence of global supply chain disruptions as well as the developments in energy prices are additional factors of uncertainty. Until 2024, GDP is expected to remain below the trend projected before the pandemic occurred. However, an effective outcome of the implementation of the Recovery and Resilience Plan could mitigate this gap. [5]

The outstanding real bank credit to non-financial corporations interrupted the upward trajectory observed since mid-2020

The outstanding real bank credit to the non-financial private sector stagnated, in the last quarter of 2021 (0% year-on-year) (Chart 2), due to a decrease in real bank credit outstanding to NFCs (-1.4% year-on-year), that outweighed the increase in real bank credit outstanding to households (1% year-on-year). The annual rate of change adjusted for securitisation operations, reclassifications, write-offs, price and exchange rate revaluations, and sales, of the outstanding real bank credit to the non-financial private sector, in November 2021, was 0.6% (year-on-year), driven by an increase in real bank credit outstanding to households (1%), whilst real bank credit outstanding to NFCs stagnated (0%).[6]

The outstanding real bank credit to NFCs interrupted the upward trajectory observed since mid-2020. As to financing conditions, spreads on new lending to NFCs remained at 2.6 p.p. in December 2021.

[3] 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 https://www.esrb.europa.eu/pub/pdf/recommendations/2014/140630_ESRB_Recommendation.en.pdf. 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.

[4] The press release for the Quarterly National Accounts for the fourth quarter of 2021 is available at https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=472473077&DESTAQUESmodo=2&xlang=en.

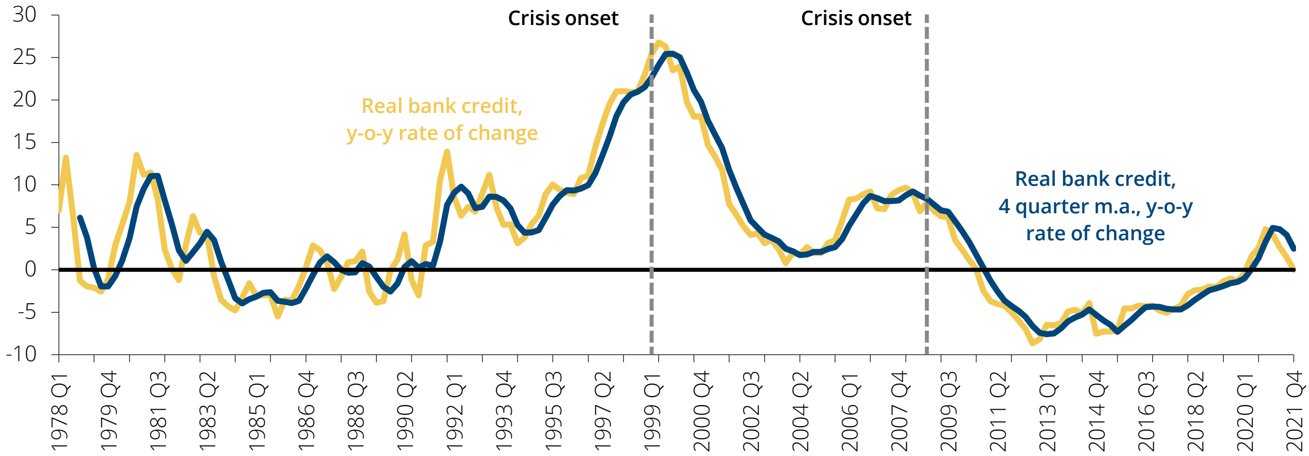
[5] The March 2022 *Economic Bulletin* of the Banco de Portugal is available at https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/be_mar2022_p.pdf (available only in Portuguese).

[6] In nominal terms the outstanding bank credit to non-financial private sector increased by 2.6 % (year-on-year) in the last quarter of 2021, due to the growth rate of credit granted to households (3.6%) and to NFCs (1.1%). In nominal terms, the annual rate of change adjusted for securitisation operations, reclassifications, write-offs, price and exchange rate revaluations, and sales, of the outstanding bank credit to the non-financial private sector, in November 2021, was 3.2% (year-on-year), driven by an increase in both credit granted to NFCs and to households (2.6% and 3.6%, respectively).

Regarding households, the year-on-year increase in outstanding real bank credit reflects an increase in credit for consumption and other purposes of 6.7% as credit for house purchase decreased 0.5%. However, when adjusted for securitisation operations, reclassifications, write-offs, price and exchange rate revaluations, and sales, the annual rate of change of the outstanding real bank credit for consumption and other purposes, in November 2021, was -1% (year-on-year), whilst increasing for house purchase (1.5%).[7] Interest rate spreads on new lending continued to reflect stable financing conditions, as spreads for mortgages reached 1.4 p.p. in December 2021, increasing by 0.1 p.p. when compared to September 2021. On the contrary, spreads on new lending for consumption and other purposes reached 5.9 p.p., in December 2021, decreasing by 0.5 p.p. when compared to September 2021.

Looking forward, and according to the January 2022 *Bank Lending Survey*[8], on the supply side, credit standards for loans to NFCs and households are expected to remain unchanged over the first quarter of 2022. The demand for loans by NFCs or by households is not expected to change.

Chart 2 • Year-on-year rate of change of real bank credit[9] | Per cent



Sources: Banco de Portugal and Statistics Portugal. | Notes: The last observation refers to 2021 Q4. 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 real house prices continued to rise in the third quarter of 2021

In the third quarter of 2021, the real house price index increased 8.6% (year-on-year), compared to a 5.7% growth rate in the second quarter of 2021 (Chart 3). The value of house transactions, albeit some volatility due to the evolution of the pandemic, also increased in the third quarter of 2021compared with the previous quarters, although at a slower pace.

Looking forward, the March 2022 Banco de Portugal's *Economic Bulletin* projects an expected growth of 5.8% for the residential gross fixed capital formation in 2022. The increase in disposable income, favourable financial conditions and the attractiveness of this type of investment, in a context of accumulation of savings, are the factors supporting the expected growth. Moreover, as detailed in the December 2021 Banco de Portugal's *Financial Stability Report*, the increase in construction costs observed in recent months, associated with a shortage of labour and materials, as well as with a higher demand from non-residents, constitute additional factors of upward pressure on house prices.[10]

[7] In nominal terms, both the outstanding bank credit for consumption and other purposes and for house purchase increased by 9.4% and 2% (year-on-year), respectively, in the last quarter of 2021. In nominal terms, the annual rate of change adjusted for securitisation operations, reclassifications, write-offs, price and exchange rate revaluations, and sales, of the outstanding bank credit for consumption and other purposes and for house purchase, in November 2021, was 1.6% and 4.1% (year-on-year), respectively.

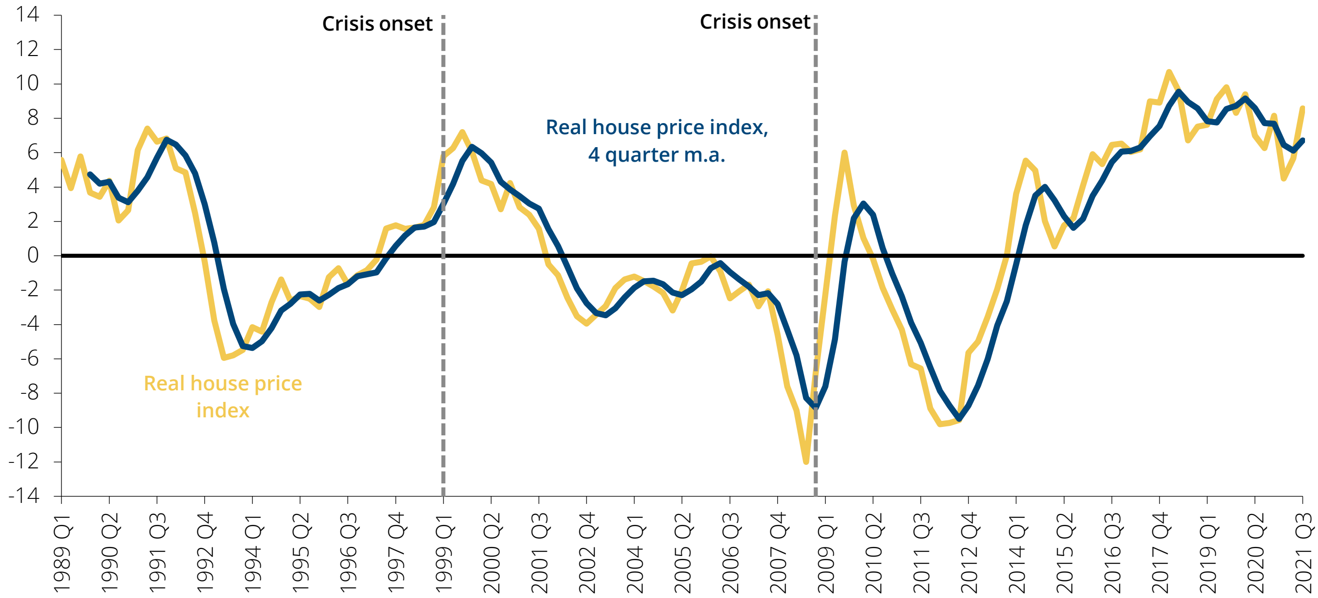
[8] More information is available at https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/results_jan2022_en.pdf.

[9] Credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector. Bank credit granted by resident monetary financial institutions as available in Monetary and Financial Statistics published by the Banco de Portugal. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by Statistics Portugal.

[10] For more details regarding house demand by non-residents as a driver of the increase in house prices in Portugal please see Box 4 of Economic Bulletin of December 2021.

According to the November 2021 *Portuguese Housing Market Survey*[11], the majority of survey respondents expect near-term sales to exhibit some dynamism and prices to continue rising at both three- and twelve-month time horizons. In addition, the results from the December 2021 *Survey on bank evaluation on housing*[12] indicate that the year-on-year growth rate of the median value of bank appraisals increased 11.2% in November 2021, which compares to 10.6% in the previous month. The number of bank appraisals rose 8.7% in November 2021, compared to a 13.7% growth rate in October 2021.

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 2021 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 composite indicator of financial stress for Portugal increased slightly, while remaining at low values, and the economic sentiment indicator remained close to pre-pandemic values

The composite indicator of financial stress for Portugal remained at low levels. It increased since October 2021 due to the uncertainty related to the renewed wave of the pandemic in Europe, to global supply chain disruptions, and to developments in energy prices.

A decrease in uncertainty regarding the impact of the pandemic crisis is nevertheless expected. This expected positive evolution is associated with the projected economic recovery and with the assumption of no significant adverse effects on aggregate economic activity with the end of some temporary support measures.

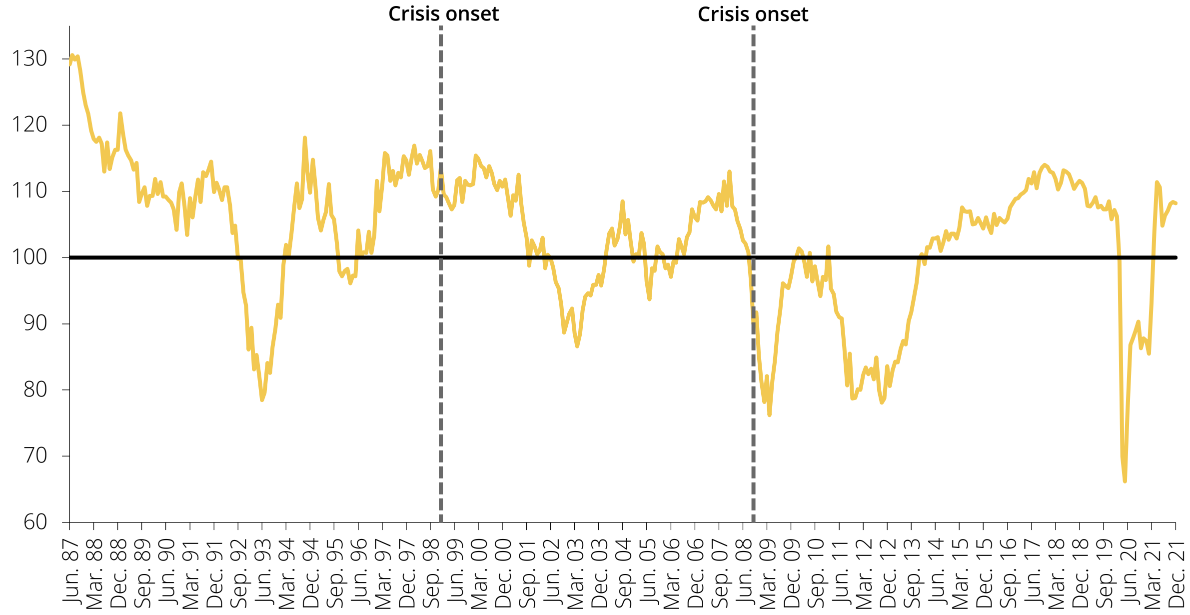
In December 2021, the economic sentiment indicator for Portugal decreased slightly, in comparison to the previous month (Chart 4), reflecting the abovementioned risks. This decrease follows from a decline in the confidence indicators of almost all sectors, except in consumption and retail. Nevertheless, it remains close to the pre-pandemic values.

[11] 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.

[12] More information is available on https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=472474943&DESTAQUESmodo=2.

[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.

Chart 4 • Economic Sentiment Indicator for Portugal | Index (2000-2020 average = 100)



Source: European Commission. | Notes: The last observation refers to December 2021. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

General assessment

In line with previous risk assessments and taking into account the above analysis, Banco de Portugal decided to maintain at 0% the countercyclical capital buffer rate over the second quarter of 2022. This decision preserves banks' ability to provide credit to the economy in the early stages of the recovery in view of the prevailing uncertainty.

Despite the recovery in economic activity, there is still uncertainty about the effects of the pandemic and the impact of the current Russia-Ukraine conflict. The global supply chain bottlenecks, the energy and other raw material prices developments, and their potential impact on households' real income and on NFCs' profit margins can affect the recovery's pace. The composite indicator of financial stress for Portugal increased slightly, although remaining at low values, and the economic sentiment indicator is close to pre-pandemic values. Finally, until now, domestic bank credit has not been the main driver behind the rise in house prices in Portugal.

Banco de Portugal will continue to closely monitor the developments in cyclical systemic risk, taking into consideration the current and the projected impact of the pandemic and of the situation in Ukraine, and may take macroprudential measures aimed at mitigating the potential build-up of systemic risk in specific sectors. In this vein, the Banco de Portugal has recently decided to implement new limits to the maximum maturity of new credit for house purchase. This revision of the Macroprudential Recommendation was justified by the fact that the average maturity of new loans for house purchase has not undergone a gradual convergence towards 30 years, as established in the Recommendation[14].

[14] More information is available at https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits.