COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

30 JUN 2021

Pursuant to the decision of the Board of Directors of 22 June 2021, 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 July 2021

After the setback in the economic recovery in the first quarter of 2021, as a result of the second lockdown, the second quarter of 2021 began with the progressive easing of the containment measures and the reopening of the economy. The larger widespread of vaccines during the second quarter of 2021 contributes to a reduction in the uncertainty regarding the evolution of the pandemic. European and national authorities continued to support non-financial corporations (NFCs) and households, namely by providing favorable financing conditions and liquidity and solvency support. Against this background, the Portuguese economy is expected to return to its recovery path.

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

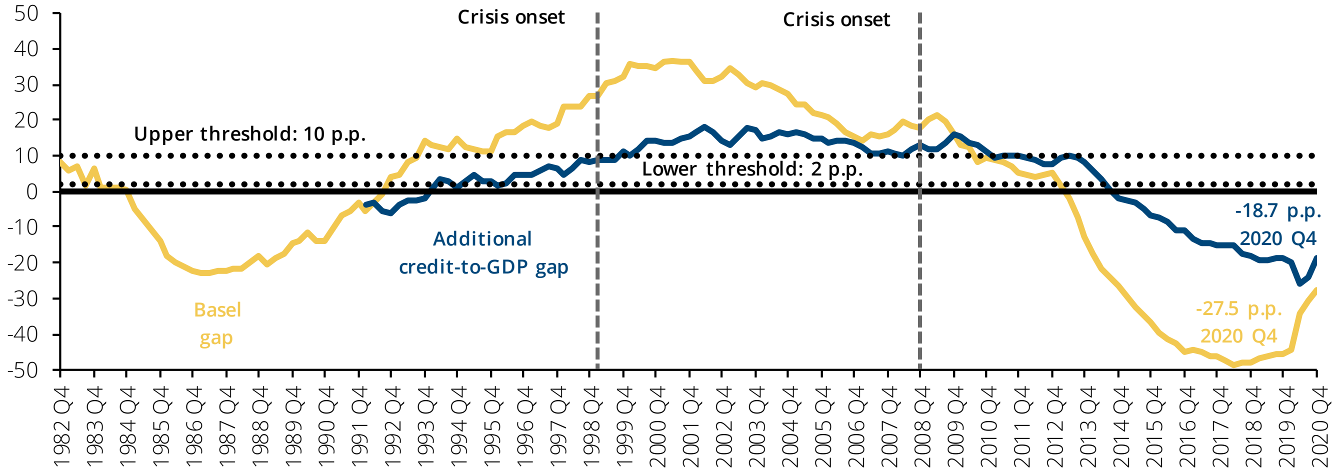
Both measures of the credit-to-GDP gap continued to increase, reflecting mainly the fall in nominal GDP

In the last quarter of 2020, the Basel gap reached -27.5 percentage points (p.p.), while the additional credit-to-GDP gap reached -18.7 p.p. (Chart 1). Both measures have continued to increase, showing a recent upward trend. However, even though the gaps have been narrowing, they remain below the threshold that would trigger a positive benchmark buffer rate (2 p.p.).

In the same quarter, the credit-to-GDP ratio increased when compared with the third quarter of 2020 (171.7% and 170.1% respectively). Despite the decrease of 0.7% (quarter-on-quarter) in credit granted to non-financial corporations, credit granted to households increased 0.6% (quarter-on-quarter). Consequently, total credit granted to the private non-financial sector fell 0.2%, when compared with the third quarter of 2020. As such, the increase in the credit-to-GDP ratio was mainly driven by the large fall in nominal GDP in the end of 2020 (-4.3% year-on-year), that outweighed the decrease in credit.

[1] The assessment is based on data available up to 4 May 2021. Any differences in figures from previous assessments are due to revisions in underlying data.

Chart 1 • Basel gap and additional credit-to-GDP gap[2] | In percentage points



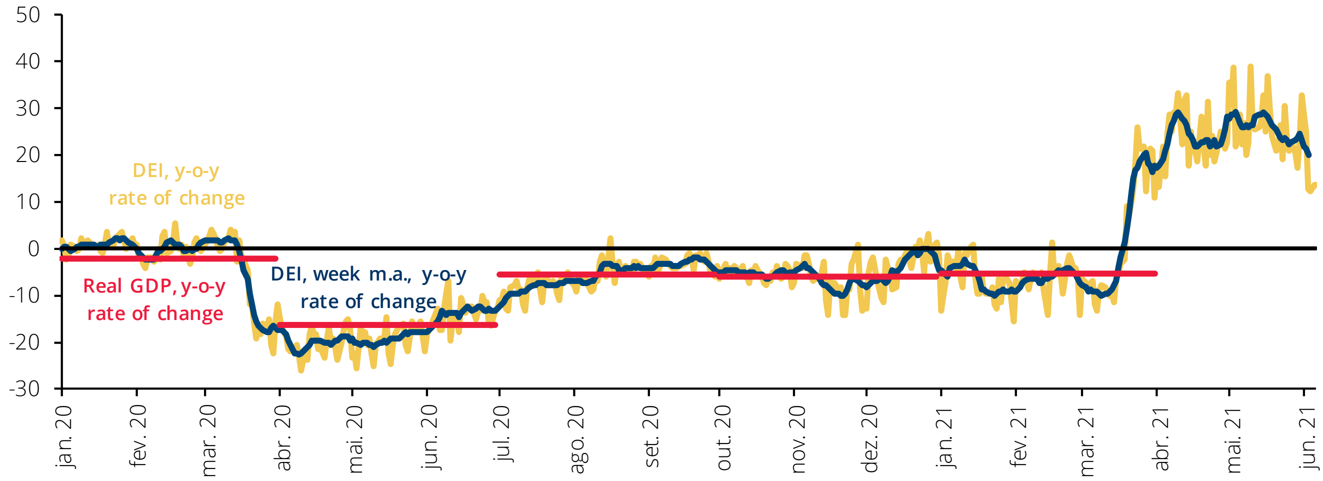
Sources: Banco de Portugal and Statistics Portugal. | Notes: The last observation refers to 2020 Q4. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Going forward, it is expected that the outstanding amount of credit increases but at a low pace, given the interaction of factors that entail opposite impacts. The March 2021 *Economic Bulletin* forecasts a substantial increase in private consumption mainly driven by accumulated savings and a favorable evolution of private disposable income, and not by credit for consumption purposes. The fall in real GDP in the first quarter (-5.4% year-on-year), as published by Statistics Portugal, reflects the containment measures associated with the second lockdown that occurred during this quarter. The daily economic indicator (DEI)[3] shows a recovery of the economic activity since the middle of March (Chart 2), reflecting the gradual elimination of the containment measures. However, it should be highlighted that the most recent evolution of the DEI is strongly influenced by base effects (i.e. due to the comparison with values observed precisely at the onset of the pandemic crisis). That said, it is expected that economic activity recovers from the second quarter onwards. In prospective terms, given the expected substantial increase in real economic activity and the moderate rise in prices and in credit over the next quarters, the credit-to-GDP ratio will most likely follow a downward path.

[2] 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 http://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.

[3] The DEI was developed by the Banco de Portugal with the goal of tracking sudden changes in the economic activity in a timely manner. More information regarding the indicator is available at https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/be_out2020_e.pdf (Box 1), at https://www.bportugal.pt/en/publications/banco-de-portugal/all/9085 and Lourenço and Rua (2020), "The DEI: tracking economic activity daily during the lockdown", *Working paper* No. 13, Banco de Portugal.

Chart 2 • Year-on-year rate of change of the daily economic indicator[4] | Per cent



Source: Banco de Portugal. | Notes: The last observation refers to 06 June 2021. m.a. stands for moving average.

Outstanding real bank credit to the private non-financial sector increased at a slower pace

Outstanding real bank credit to the private non-financial sector increased 4.2% (year-on-year) in the first quarter of 2021 (Chart 3). This increase reflects a 7.8% and a 1.7% (year-on-year) increase in outstanding real bank credit to NFC and households, respectively. The hike in outstanding real bank credit to households was driven by the increase of credit for house purchase (2.5% year-on-year), since credit for consumption and other purposes decreased 1.4% (year-on-year).

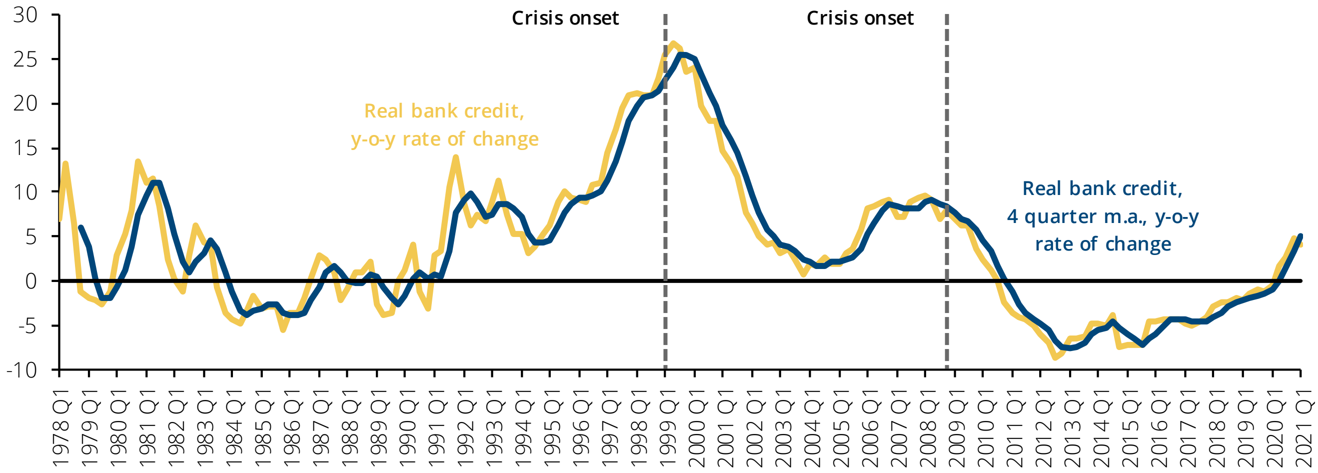
Going forward, and according to the April 2021 *Bank Lending Survey*[5], banks expect to apply tighter credit standards during the second quarter of 2021, both to loans to NFCs and households (for house purchase and for consumption and other purposes). However, the credit supply conditions observed until the first quarter of 2021 are substantially less tight than those observed during the financial and sovereign debt crises. For the demand of credit, banks expect a slight decrease from NFC and a slight increase from households, both in credit for house purchase and credit for consumption and other purposes.

Interest rate spreads on new lending have remained stable as of the beginning of the COVID-19 pandemic, reflecting the success of monetary policy in keeping financial conditions stable. After a slight decrease in February 2021, interest rate spreads on new lending to NFC increased to 2.5 p.p. in March 2021. However, they remain close to pre-pandemic values. Regarding the households segment, since November 2020 spreads and interest rates applied to new loans for house purchase have remained constant at 1.3 p.p. and 0.8% respectively. Interest rates applied to loans for consumption and other purposes show some fluctuation around pre-pandemic values, reaching 5.2% in March 2021.

[4] The year-on-year rate of change of real GDP in the first quarter of 2021 corresponds to the flash estimate published by Statistics Portugal.

[5] More information is available at https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/results_apr2021_en.pdf

Chart 3 • Year-on-year rate of change of real bank credit[6] | Per cent



Sources: Banco de Portugal and Statistics Portugal. | Notes: The last observation refers to 2021 Q1. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Real house prices continued to rise in the last quarter of 2020

In the last quarter of 2020, the real house price index increased by 7.9% year-on-year (Chart 4). This growth rate is somewhat higher than the growth rates observed in the second and third quarters of 2020 but below the one observed at the beginning of 2020. The number of house transactions also increased in the fourth quarter of 2020, with a year-on-year rate of change of 1.0%, which compares with a rate of change of -1.5% in the third quarter of 2020 and of -21.6% in the second quarter of 2020. On the supply side, in the fourth quarter of 2020 building permits and completed buildings decreased by 1.0% and 4.1% (year-on-year), respectively.

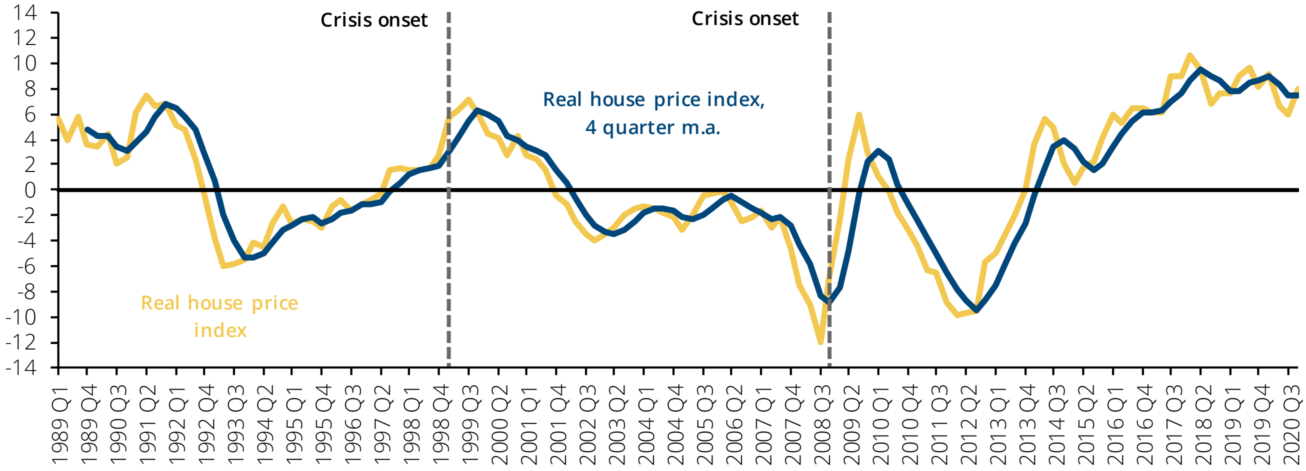
The overall resilience of residential real estate prices benefits from the ECB's accommodative policy in tandem with the continued support measures that mitigate liquidity constraints and the risk of default. Moreover, since the introduction of the macroprudential Recommendation, an improvement in the new borrowers' risk profile has been observed. Furthermore, market expectations point to a protracted period of very low interest rates, thus lowering the probability of a sudden and abrupt downward correction of house prices. Going forward, the evolution of residential real estate risks in the medium term and the risks for a price correction heavily depend on the path of the economic recovery, namely on the resilience of employment and households' disposable income and on the recovery of tourism related sectors, together with the adequacy of the policy mix. Nevertheless, if tail risk materializes, the LTV distribution of the banks' mortgage portfolio should be able to accommodate a potential non-negligible fall in house prices, without incurring in significant losses

Overall, the March 2021 *Portuguese Housing Market Survey*[7] suggests that participants' expectations are improving. Most of the participants in this survey still expect a decrease in house prices over the next three months' horizon, but there was a decrease in the percentage of participants that signalled a negative outlook. At the twelve months' horizon price expectations moved into positive territory for the first time since July 2020. In what regards near term sales, participants' expectations point to an increase in sales volumes across all regions over the next three months. In the rental market, the participants anticipate rental growth to remain marginally negative in the short term.

[6] 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.

[7] 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.

Chart 4 • Year-on-year rate of change of house prices, in real terms[8] | Per cent



Source: Organization for Economic Co-operation and Development. | Notes: The last observation refers to 2020 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 composite indicator of financial stress for Portugal is now below pre-pandemic levels

After the peak observed at the onset of the pandemic in March 2020, the composite indicator of financial stress for Portugal has been decreasing, reaching in May 2021 a value that is below pre-pandemic levels (Chart 5). The policy measures taken in order to curb the effects of the pandemic – both in direct support of the real economy and in protecting and stabilizing financial markets – have been key to contain a surge in financial stress that could negatively affect the real economy.

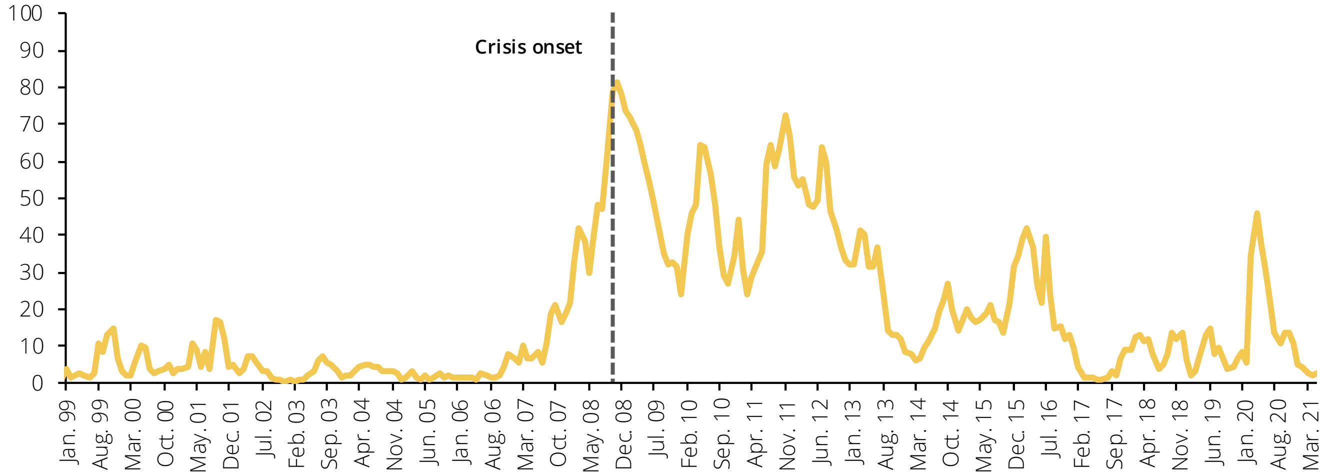
Looking forward, the maintenance of low levels of financial stress will largely depend on the expected recovery of GDP, following the gradual ease of lockdown measures and the withdrawal of support measures, and on the continuity of the ECB's accommodative monetary policy. An adequate phasing out of the support measures, in order to avoid cliff edge effects, would be also of utmost importance.

The economic sentiment indicator for Portugal resumed the recovery path

The implementation of new lockdown measures at the beginning of 2021 led to a stabilisation of the economic sentiment indicator for Portugal at levels above its lowest ever figure, observed in May 2020, but below its long-term average (Chart 6). In April 2021, the economic sentiment indicator rose with the prospects of a speedier process of vaccination and of easing of the lockdown measures in the short term. This positive evolution reflects an improvement in all sub-indicators *vis-à-vis* the preceding month. The sub-indicator related to the services sector (which includes tourism, restaurants and entertainment) was the one that displayed the highest increase. In the following quarters, the indicator is expected to keep increasing reflecting the expected improvement in the economic outlook.

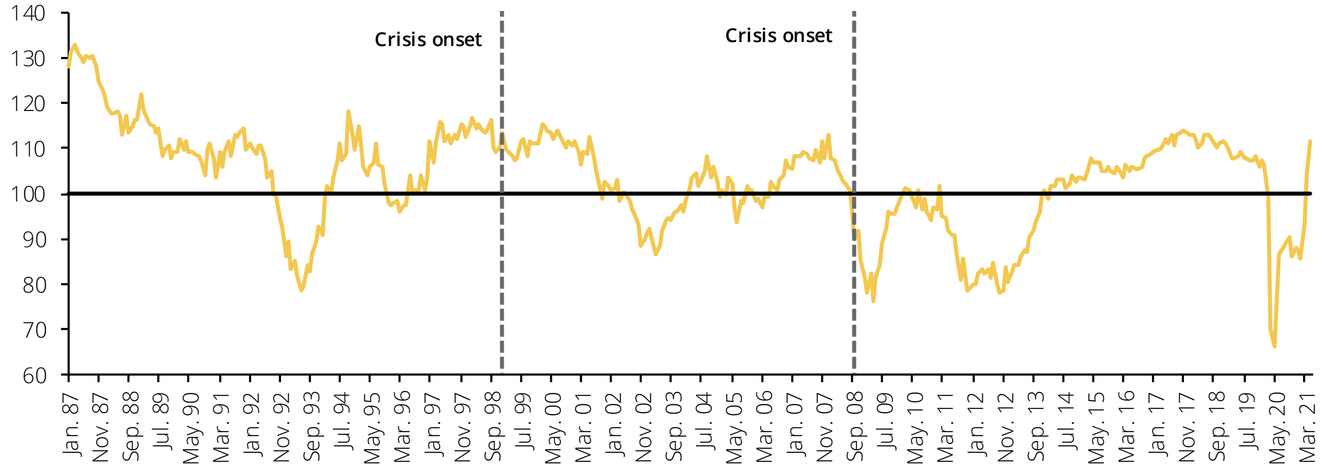
[8] Real house price index (2015=100) published by the Organization for Economic Co-operation and Development. The house price index is adjusted for inflation using the private consumption deflator (2016=100) taken from the National Accounts (ESA2010, base 2016) published by Statistics Portugal.

Chart 5 • Composite Indicator of financial *stress* for Portugal[9] | Quantile Rank



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

Chart 6 • Economic Sentiment Indicator for Portugal | Index (2000-2020 average = 100)



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

General assessment

In line with the previous risk assessment and taking into account the above analysis, the Banco de Portugal has decided to maintain at 0% the countercyclical capital buffer rate over the third quarter of 2021. Along with other measures in place, this decision is expected to contribute to ensure that financial institutions keep providing credit to the economy and have the necessary capital to absorb potential losses that may arise from the materialization of risks. Notwithstanding, the 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.

[9] For more information on the composite indicator of financial stress see Braga, J. et.al (2014), "Composite Indicator of Financial Stress for Portugal", *Financial Stability Papers*, Banco de Portugal, available at https://www.bportugal.pt/sites/default/files/anexos/papers/paper_1_en_0.pdf .