COUNTERCYCLICAL CAPITAL BUFFER

30 September 2019

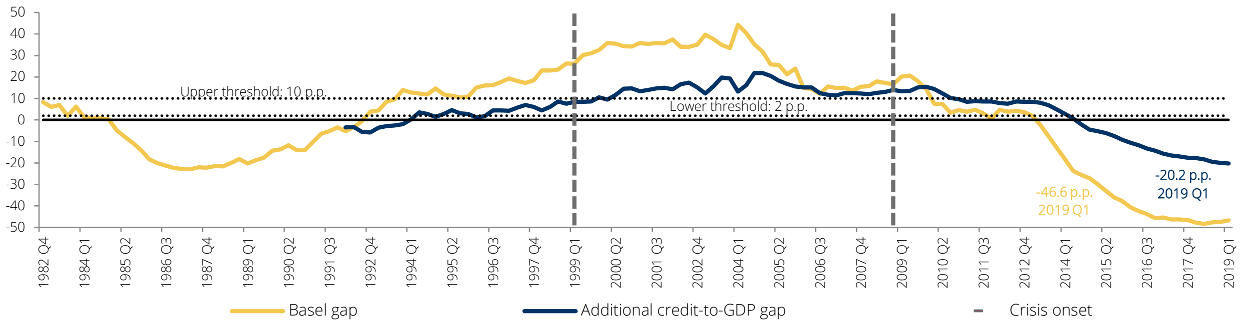
Pursuant to the decision of the Board of Directors of 24 September 2019, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 October 2019.

This decision is based on the overall assessment of a set of financial and macroeconomic indicators.[1]

Credit-to-GDP gap remains in negative territory

In the first quarter of 2019, both the Basel gap and the additional credit-to-GDP gap remained negative and significantly below the risk level threshold of 2 p.p., reaching -46.6 p.p. and -20.2 p.p., respectively (Chart 1). The credit-to-GDP ratio has maintained the downward trajectory initiated in 2013, as the nominal GDP increased at a higher rate than the total credit outstanding to the private non-financial sector (quarter-on-quarter).

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



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation refers to 2019Q1. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

[1] The assessment is based on data available up to 30 July 2019. Any differences in figures from previous assessments are due to revisions in underlying data. The set of indicators covers the six categories set out in Recommendation ESRB/2014/1.

[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?03a7c5c908620b34673b6f290b54c13d. 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.

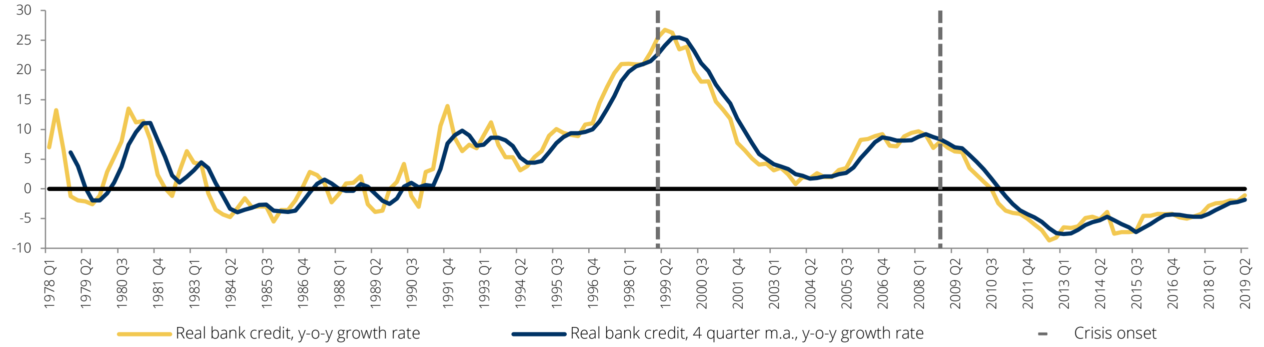
The projections published in the June 2019 *Economic Bulletin* of Banco de Portugal for the period 2019-21 point to (i) a trajectory of expansion of the GDP, albeit at a slower pace than that observed in the recent years, as the economic cycle matures, and (ii) a maintenance of the path of reduction in the indebtedness ratios[3] of the private non-financial sector, although decelerating. Against this background, a change in the sign of both gaps is unlikely to occur in the next quarters.

Hence, according to these indicators, the implied benchmark countercyclical buffer rate remains at 0% of the total risk exposure amount.

Real bank credit continued to decline

In the second quarter of 2019, real bank credit outstanding to the private non-financial sector declined by 1.1% (year-on-year) (Chart 2), due to the contraction of real bank credit outstanding to non-financial corporations (NFCs) (-2.7%). Regarding real bank credit outstanding to households, it remained broadly stable over the same period (0.1%), with the year-on-year growth rate returning to positive territory for the first time since the end of 2010, reflecting the combined effect of the reduction in real bank credit for house purchase (-0.2%) and the increase in real bank credit for consumption (8.7%). However, while real bank credit for house purchase has been recording a gradually smaller decline, real bank credit for consumption has been decelerating in the last quarters.

Chart 2 Real bank credit growth[4] | In percentage



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation refers to 2019 Q2. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

According to the June 2019 *Economic Bulletin* of Banco de Portugal, the increase in consumer loans is associated with favourable developments in real household disposable income, in line with the previous quarterly assessment. Additionally, in a context of high consumer confidence, Banco de Portugal projects, for 2019, (i) an acceleration of current consumption of goods and services, and (ii) a slowdown of consumption of durable goods, strongly influenced by the motor vehicle component dynamics in the beginning of the year. In this context, new loans for consumption have been exhibiting a year-on-year decline since the fourth quarter of 2018.

In the first quarter of 2019, the ratio between the annual change in bank credit to the private non-financial sector and the five year moving average of nominal GDP decreased by 0.7 p.p., to -5.6% (quarter-on-quarter), reflecting both the contraction of bank credit and the gradual increase in nominal output.

Real total credit outstanding to the private non-financial sector continued to decline in the first quarter of 2019 (-1.5%, year-on-year), as a result of a decrease in real total credit outstanding to both NFCs and households (-2.3% and -0.3%, respectively).

[3] Measured by NFCs' debt in percentage of GDP and by households' debt in percentage of disposable income.
[4] Credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector. Bank credit extended by resident monetary financial institutions as available in Monetary and Financial Statistics published by Banco de Portugal. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by INE.

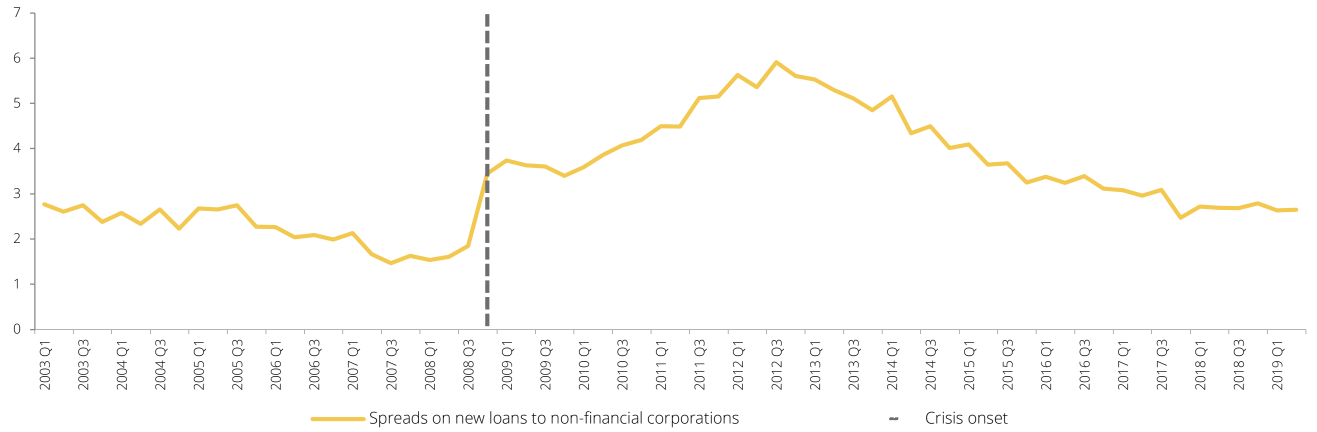
Furthermore, according to the May 2019 *Economic Bulletin* of Banco de Portugal, in 2018, the number of new loans granted by resident financial institutions to low-risk NFCs continued to increase, whereas that to high-risk NFCs followed an opposite trajectory. Regarding the households' segment, the macroprudential Recommendation issued by Banco de Portugal, which entered into force on 1 July 2018, helped reduce the share of credit granted to borrowers with a higher risk profile, as highlighted in the May 2019 Progress Report.[5]

Lending spreads on new loans stood broadly stable

In the second quarter of 2019, spreads on new lending granted to the private non-financial sector stood stable, when compared with the levels observed in the previous quarter.

In the households' segment, new lending spreads for house purchase remained at 1.6 p.p. in the second quarter of 2019, in comparison with the previous quarter, whereas those related to new lending for consumption and other purposes reached 6.4 p.p., increasing by 0.1 p.p.. Regarding NFCs, new lending spreads (up to one year) remained at 2.6 p.p., over the same period (Chart 3). Moreover, according to the June 2019 *Financial Stability Report* of Banco de Portugal, in 2018, lending spreads associated to new loans to NFCs continued to be differentiated according to credit risk.

Chart 3 Spreads on new loans to non-financial corporations[6] | In percentage points



Sources: Banco de Portugal, Refinitiv and Banco de Portugal calculations.
Notes: The last observation refers to 2019 Q2. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

In June 2019, the average interest rate on new lending to households for house purchase reached 1.3%, decreasing by 0.1 p.p., when compared to March 2019, whereas for consumption and other purposes it increased by 0.1 p.p. to 6.1%. Considering the same period, the average interest rate on new lending to NFCs (up to one year) stood at 2.3%.

According to the July 2019 *Bank Lending Survey*, in the second quarter of 2019, demand for credit by firms remained broadly unchanged compared with the previous quarter, whereas, in the households' segment, there was a slight increase in the demand for housing loans and consumer credit, justified by the general level of interest rates and consumer confidence, respectively. On the supply side, over the past three months, credit standards and overall terms and conditions of loans granted to firms and households remained broadly unchanged compared with the previous quarter. Going forward, banks do not anticipate, in the third quarter, major changes in credit supply but expect a small decrease in the demand for credit by SME, as well as for long term loans by firms. In the households' segment banks expect an increase in the demand for loans for house purchase.

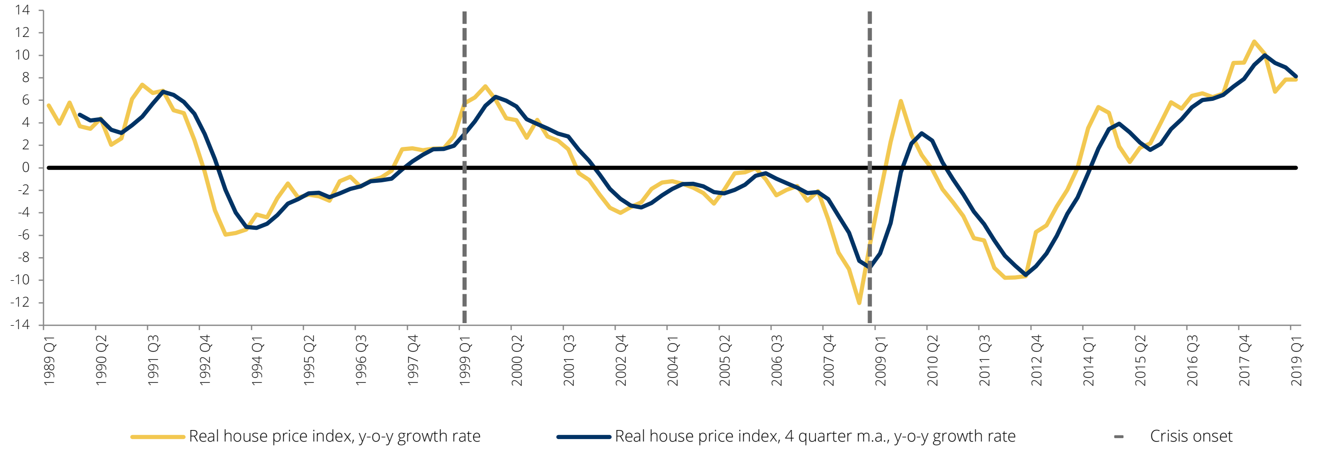
[5] More information on this macroprudential measure is available at https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits.

[6] Average of spreads weighted by the corresponding outstanding loan amounts at the end of the quarter. The spread is calculated against the three month Euribor rate, as available in Refinitiv. Only interest rates on new loans granted by other monetary financial institutions to residents with initial rate fixation up to one year (as available in Monetary and Financial Statistics published by Banco de Portugal) are considered.

Maintenance of residential house prices growth

In the first quarter of 2019, real house prices increased by 7.8% (year-on-year), maintaining the year-on-year growth rate registered in the previous quarter, but remaining below the peak observed in the first quarter of 2018 (11.3%) (Chart 4).

Chart 4 Year-on-year growth rate of house prices, in real terms[7] | In percentage



Sources: Organization for Economic Co-operation and Development.
Notes: The last observation refers to 2019 Q1. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

In the fourth quarter of 2018, house prices, in aggregate terms, remained slightly above their economic fundamentals, according to the ECB average valuation measures for detecting residential property price misalignments from fundamentals.[8] Those economic fundamentals comprise real disposable income per household, real housing stock per capita and real average interest rate loans for house purchase.

According to the June 2019 *Economic Bulletin* of Banco de Portugal, housing investment is expected to continue to recover, with a significant increase projected for 2019, largely influenced by the strong growth in the first months of the year. As to the 2019-21 horizon, and despite a progressive deceleration of housing investment anticipated for 2020-21 (to growth rates of around 3% in 2021), housing investment is expected to continue to increase, reflecting the maintenance of a set of factors that have boosted demand for housing. These include the improvement in the labour market, ongoing access to financing at historically low interest rates, and the strong increase in tourism and demand by non-residents. The increase in profitability relative to other long-term investments, partly reflecting the sharp growth of housing prices since 2014, has also contributed to the recovery in housing investment.

On the supply side, as reported by Statistics Portugal, in the first quarter of 2019, the number of building permits registered an increase of 10.7%, compared with the same period of the previous year (28.1% in the fourth quarter of 2018) and completed buildings increased by 7.2% (18.8% in the fourth quarter of 2018).[9] Therefore, considering the lagged impact of the rise in building permits issued on housing supply, the latter is expected to continue to gradually recover. This, coupled with the aforementioned progressive deceleration of housing investment anticipated for 2020-21, may help curb the ongoing increase of house prices.

[7] 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 (2010=100) taken from the National Accounts (ESA2010, base 2011) published by Statistics Portugal.

[8] For more details, see Box 3 in the *Financial Stability Review*, European Central Bank, June 2011 and November 2015.

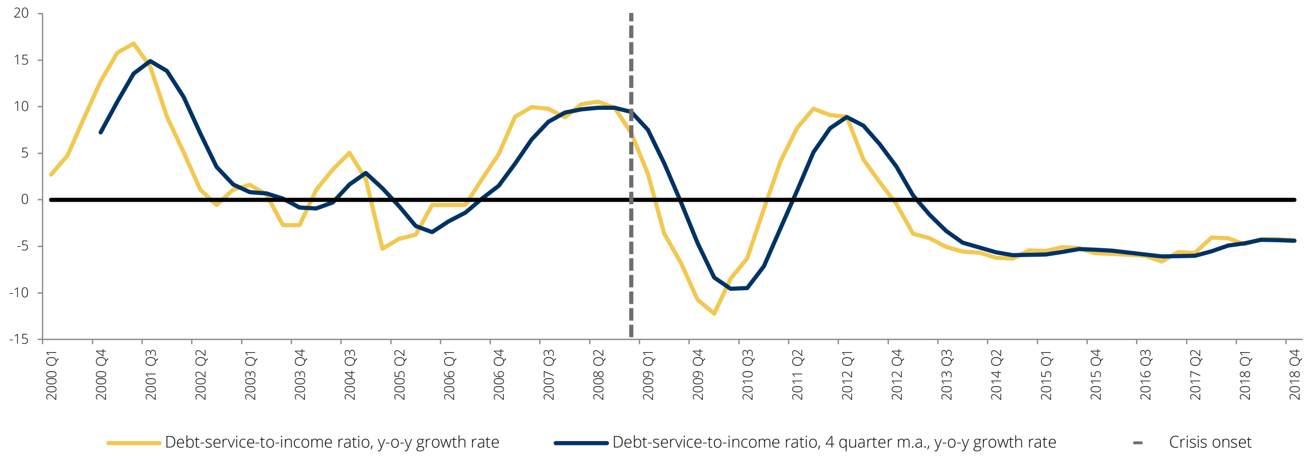
[9] Data are available at Statistics Portugal website at https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=354080818&DESTAQUESmodo=2.

The evolution of additional indicators did not change significantly when compared to the previous quarter

In the first quarter of 2019, the loan-to-deposits ratio decreased by 1.3 p.p. to 87.7%, when compared with the previous quarter, explained by loans reduction and, mainly, deposits increase, continuing the downward trajectory from its peak, in June 2010.

Debt-service-to-income ratio[10] of the private non-financial sector contracted further, in the fourth quarter of 2018, from 16.2% to 15.5% (year-on-year) (Chart 5). According to the June 2019 *Economic Bulletin* of Banco de Portugal, (i) the low interest rate regime, which has been in place over the last few years, thus contributing to the maintenance of private debt servicing at low levels, and (ii) the gradual reduction of the slack in the labour market and the increase in productivity should contribute to some acceleration in wages per worker over the projection horizon 2019-21. Accordingly, and considering the expected scenario of low interest rate levels, at least through the first half of 2020,[11] and the expected reduction in the indebtedness ratios, a material increase in the debt-service-to-income ratio is not foreseen in the near future.

Chart 5 Year-on-year growth rate of debt-service-to-income ratio | In percentage



Sources: BIS and Banco de Portugal calculations.
Notes: The last observation refers to 2018 Q4. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

In the first quarter of 2019, the seasonally adjusted current account deficit increased by 0.7 p.p. to 1.0%, in percentage of GDP, when compared with the previous quarter.

According to the June 2019 *Economic Bulletin* of Banco de Portugal this is largely due to the increase in the goods account deficit at the end of 2018 and the beginning of 2019, driven by the strong growth of equipment goods imports, in a context of a significant increase in business investment. Regarding the services account, its surplus has increased steadily, which is expected to continue over the projection horizon 2019-21, although at a slower pace. However, these developments are not enough to offset the goods account balance, resulting in a gradual deterioration of the goods and services account balance to negative levels from 2019 onwards. Nonetheless, over the projection horizon, the Portuguese economy should continue to benefit from a relatively benign economic and financial environment, with external demand for Portuguese goods and services expected to grow slightly below 3% on average, decelerating in 2019 and recovering in the following years.[12] However, the June 2019 Economic Bulletin of Banco de Portugal identifies a set of risks, largely associated to the international environment, which translate into the probability of developments in external demand for Portuguese goods and services being less favourable than those considered in the projection.

[10] Debt-service-to-income ratio estimates published by the Bank for International Settlements for the private non-financial sector, which uses gross disposable income as a proxy for income. Available at http://www.bis.org/statistics/dsr.htm.

[11] For more details, see https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190725~52d3766c9e.en.html.

[12] This projection includes the Eurosystem exercise published recently by the ECB, using the underlying set of external assumptions.

The deterioration of the goods and services account balance should be accompanied by an improvement of the income and capital account balances, reflecting the expected increase of the amount of funds received from the EU over the projection horizon.[13] Developments in the income account balance benefit from the ongoing low interest rates and the reduction in interest on public debt. Concerning the capital account balance, it is projected to increase in 2021 due to a one-off effect associated with the reimbursement by the European Financial Stability Facility of amounts paid by Portugal under the Economic and Financial Assistance Programme. In this context, the economy's net lending capacity, measured by the current and capital account balance, is expected to stabilise on average over the projection horizon at around 0.2% of GDP.

General assessment

In line with the previous risk assessment, and despite the developments in the residential real estate market and the current account balance, there is no overall evidence of emerging cyclical systemic risk in Portugal. Hence, the countercyclical buffer rate is maintained at 0% over the fourth quarter of 2019. Nevertheless, Banco de Portugal will continue to closely monitor the developments in the different areas assessed in this note, given their interlinkages with financial stability risks.

[13] For a more in-depth analysis, see Box 2 entitled "Impact of EU funds on the current and capital account: Portugal 2020 in perspective", in the March 2019 *Economic Bulletin* of Banco de Portugal.