**The 27.07.2020 decision on setting the countercyclical capital buffer rate**

**The countercyclical capital buffer (CCyB) rate for the exposures to Latvian residents has been set at 0%. The established CCyB rate will be used to calculate a credit institution-specific CCyB rate from 1 August 2021. The Financial and Capital Market Commission (FCMC) will decide about the necessity to set the CCyB rate above 0% if significant rise in cyclical systemic risks is recorded in Latvia's financial sector.**

The FCMC, as an institution responsible for the application of the CCyB according to Article 35.5 of the Credit Institution Law, analyses the credit-to-GDP ratio every quarter, as well as its deviation from the trend and the additional indicators to justify the decision on the CCyB rate.

The FCMC has been monitoring latest developments regarding the global supply-demand shock resulting from a coronavirus (Covid-19) outbreak and the effects it has on Latvia’s economy. These effects began to manifest themselves starting from March as the GDP growth rate in Q1 2020 fell into negative territory for the first time since 2010 decreasing by 1.5% compared to the same period in 2019.

Current revised forecasts for GDP growth highlight an even larger expected annual decrease of 7.5% for 2020 compared to the 6.5% drop forecasted in March. Although the first wave of pandemic has slowed down and European countries are starting to lift some restrictions, the uncertainty surrounding future developments still remains and the possibility of a second wave in autumn leads to a cautious cyclical policy and setting of the CCyB rate. Various government support mechanisms have already been activated or are being considered to limit further damage to the economy.

The overall economic growth slowdown in Latvia is reflected in household consumption which dropped significantly (by 4.5%) during first three months of 2020 comparing to the same period in 2019 mostly due to consumers cutting costs for transport and services such as cancelled holidays and other recreational and cultural events in the light of restrictions to contain pandemic expansion. Although average gross wages increased in Q1 2020 (year-on-year) by 6.6%, uncertainty towards the depth and length of pandemic has increased consumer caution which is reflected in their spending patterns and as a result it is estimated that private consumption will drop around 6.3% during 2020. The unemployment level in May grew by 3.3% compared to same period of previous year and reached 9.6%.

At the start of pandemic restrictions in mid-March, the overall level of interest for housing loans dropped significantly and in following months many consumers instead opted to spend available income and savings for the overall improvement of existing living conditions (repairs, decoration). Currently the interest for housing loans has been restored to pre-pandemic levels but the banks have tightened their lending standards in line with increased risks, therefore the overall activity in housing market has decreased. Rental apartment segment proved to be more sensitive towards economic disruptions as overall rental price in Riga Centre area decreased by roughly 30%.

While in the short term experts do not predict significant price decreases in housing market segment, a second wave of pandemic outburst or any worsening of the current conditions might change this situation. Overall, housing prices are still growing - unadjusted data for Q1 2020 shows that the housing price index set by the Central Statistical Bureau increased by 9.1% compared to the same period in 2019 (existing house prices increased by 7.7% and new house prices increased by 15.7%). This growth rate still remains in sync with the wage growth as the ratio between the housing price index and real net salary index has been hovering around 1.00 since 2009 (reaching 1.01 in Q1 2020).

Restrictions to contain the Covid-19 pandemic (in particular, quarantine and self-isolation requirements) have significantly affected business operations leading to losses of various degrees depending on the sector of the economy. The most affected segments are transport and storage, accommodation and food services, as well as arts and entertainment and recreation. It is expected that Q2 2020 will mark further losses for companies in these sectors and any other connected to those sectors. Furthermore, the overall demand in both internal and external markets has been decreasing and this has negatively affected both export and import levels – data for April shows a year-on-year decrease of 13.9% (export) and 27.4% (import) respectively. The uncertainty in external markets and estimated reduction in consumption are expected to lead to a further weakening of the economic growth in Latvia.

Contrary to the overall trend some sectors managed to grow in Q1 2020 comparing to 2019 (year-on-year). Due to a warm winter and favourable conditions, growth was observed in construction, agriculture and forestry, as well as in commercial services, real estate activities and public services.

Even though the economic growth in previous periods was not driven by bank lending, the issuance of loans to the domestic non-financial sector has been growing as of Q1 2020 – although, if viewed in proportion to the GDP dynamics (rolling average), a decrease can be observed. Furthermore, the overall private sector debt burden continues to decrease as total interest payments to GDP plummeted to 1.1% (the lowest since 2003). In Q4 2019 the growth rate of total lending to the private non-financial sector increased by a mere 1.1% compared to the same period in 2018. In following months, the decrease in lending is expected.

Loans issued by credit institutions to private non-financial sector in Q1 2020 decreased by 3.6% compared to the same period in 2019 whereby the biggest contributor were loans to non-financial corporations (decrease by 7.7%), particularly loans to the small and medium enterprises segment (decrease by approximately 19%). The household portfolio, in contrary, exhibited growth, if only by a mere 0.6%, in Q1 2020 (year-on-year) mostly due to growth in consumer loans (by approximately 3.2%).

Issuance of state supported housing loans to resident households’ factors in the overall credit growth in 2020. In Q1 2020 domestic housing loans grew by 0.8% in terms of volumes and by 5.6% in terms of transactions.

An overall decrease in economic activity due to the Covid-19 pandemic expansion has also affected lending to non-bank lending sector. This trend could continue also in the following quarters. Loans issued by non-bank financial institutions to the private non-financial sector grew by 2.3% in Q1 2020 (year-on-year) which was 2.1 percentage points lower than in Q4 2019. Leasing companies’ credit issued to domestic households and non-financial corporations grew only by 0.6% in Q1 2020 compared to a 3.6% growth observed in Q4 2019 (year-on-year). Rising unemployment level and pessimistic future views serve as limiting factors for the demand for loans. However, contrary to this trend, in Q1 2020 (year-on-year) a subsector of non-bank lenders mainly comprising of payday loan issuers increased its credit portfolio by 8.1% compared to 3.3% growth in Q4 2019. This increase can partly be explained by growing households’ demand for extending current liabilities (grace period and extension of the term of agreement), and by structural changes observed in non-bank lenders’ credit portfolios given current obstacles for the cession of problematic loans to out-of-court debt collectors.

Overall, the assessment of cyclical risks and the policy stance at this stage is cautious. This is consistent with a shift in the macroprudential stance on a European level as many countries have responded[[1]](#footnote-1) to the Covid-19 associated negative shock to the economy by decreasing or fully releasing the CCyB in order to promote continued lending during the downswing phase of the financial cycle. Taking into account the shock to the economy from the coronavirus outbreak, signals of increased financial stability risks can be observed while the financial cycle is expected to shift downwards. High uncertainty is expected to slow down the flow of new investment in Latvia by around 12% in 2020 (basic scenario forecast). An overall slowdown in the global economic activity will decrease export levels, and declining domestic consumption will negatively affect domestic economic activity. It is expected that growing unemployment will remain an issue also in the mid-term leading to lower labour costs and slower wage growth.

The FCMC in cooperation with the Bank of Latvia continue to analyse relevant indicators and trends and will update the setting of the CCyB rate on a quarterly basis

1. Information regarding current and future CCyB rates in European Union Member States, European Economic Area (EEA) countries and United Kingdom is available on the European Systemic Risk Board homepage: <https://www.esrb.europa.eu/national_policy/ccb/html/index.en.html> [↑](#footnote-ref-1)