**The 27.10.2020 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 November 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 coronavirus (Covid-19) outbreak developments and the effects of the resulting global supply-demand shock on Latvia’s economy. According to the Central Statistical Bureau (CSB) in Q2 2020 the economy plummeted by 8.9% (year-on-year) mostly due to a large volume drop in manufacturing and services.

The annual GDP growth forecast for 2020 has been updated in September to -4.7% (previously estimated at -7.5%). Currently available data from July and August as well as results of the business confidence survey[[1]](#footnote-1) carried out by the CSB signal that the rate of economic slowdown has already reached its nadir. In light of resurgent economic activity quarterly results are from now on expected to improve for the remainder of the year, even though in case of certain industries such as transport and tourism the negative effects will be more protracted. Moreover, Covid-19 related risks are again on the rise as many European countries, including Latvia’s neighbour-countries, are seeing cases resurface. Effective containment of the virus will be a crucial factor that will directly affect the growth of Latvia’s economy going forward.

Restrictions to contain the Covid-19 pandemic (in particular, quarantine and self-isolation requirements) have significantly affected business operations leading to losses of various degree depending on the sector of the economy. In Q2 2020 (year-on-year) the most affected segments were accommodation and food service activities (decreased by 63.4%), arts, entertainment and recreation (46.3%) and transportation and storage (26.6%, wherein provision of passenger traffic services dropped by 69.3%) largely as a result of restrictions imposed by governments of Latvia and other countries. However, contrary to general trend, wholesale of information and communication equipment rose by 19.3%, aided by the necessity to implement solutions for remote work and studies during the pandemic. The overall demand in both internal and external markets has been decreasing and this has negatively affected both export and import levels – the volume of goods and services in Q2 2020 (year-on-year) decreased by 12.5% (export) and 15.3% (import). The uncertainty in external markets and potential further reduction in consumption can result in a further weakening of the economic growth in Latvia.

The overall economic slowdown was also reflected in household consumption which in Q2 2020 plunged by 20.9% (year-on-year) as households spent less on transport (drop by 26.5%) and holidays and other recreational and cultural events were cancelled (drop by 74.5%). Likewise, the spending on accommodation and catering services dropped by 63.2% (year-on-year).

Concurrently with the introduction of the pandemic-related restrictions, the overall level of demand for housing loans dropped significantly in mid-March and in following months many consumers instead opted to spend available income and savings for the improvement of existing living conditions (repairs, decoration). However, in summer, compared to the situation in spring, the overall activity rose as the number of transactions in the real estate market of Riga in July grew by 29% month-to-month. Price level in Riga’s standard residential housing market segment decreased only insignificantly in August And the rental apartment segment, after having reacted more sensitively to economic disruptions, has returned to the rent level previously observed in the beginning of the year in large part due to increased demand from students.

While in the short term significant price decreases in housing market segment are not expected, a second wave of pandemic outburst or any worsening of the current conditions might change this situation. Overall, house prices are still growing, but at a slower rate than before the pandemic - the housing price index as calculated by the CSB (unadjusted data) increased by a mere 1.6% in Q2 2020 compared to the same period in 2019 (existing house prices decreased slightly by 0.1% and new house prices increased by 9.2%).

Domestic credit has also been negatively affected as the overall issuance of loans to the domestic non-financial sector saw a decrease of 0.02% (year-on-year) in Q1 2020. Furthermore, the overall private sector debt burden continues to decrease as total interest payments to GDP have plummeted to 1.1% (the lowest since 2003).

Loans issued by credit institutions to private non-financial sector in Q2 2020 decreased by 3.6% compared to the same quarter in 2019, mostly accounted by decrease in loans to non-financial corporations (dropped by 7.0%) and consumer loans in household portfolio (4.6%). The total domestic household portfolio, however, grew by 0.3% in the same period, due to increase in loans collateralized by residential immovable property (by 1.0%).

Notwithstanding the economic slowdown, issuance of state supported housing loans to resident households’ still factors significantly in the overall credit growth. In Q2 2020 domestic housing loans grew by 3.1% in terms of transactions, while there was a slight decrease (of 0.1%) in terms of volume (year-on-year).

The overall decrease in economic activity has also left its impact on lending by non-bank financial institutions, as their issuance of credit to domestic households and non-financial corporations decreased by 4.1% in Q2 2020 (year-on-year), while leasing companies’ loans in the same period decreased even more - by 4.5%. The tightening of credit standards, negative effect of the economic shock on income levels and high uncertainty are among the main contributing factors explaining the decrease. Following this trend, in Q2 2020 (year-on-year) a subsector of non-bank lenders mainly comprising of payday loan issuers endured a drop in their household lending of 3.7%. This contraction, in contrast to the strong growth of previous quarters, can also be to some extent explained by recent amendments to the Consumer Protection Law that provisioned higher crediting standards and tighter conditions for loan issuance.

Overall, the assessment of cyclical risks and the policy stance at this stage is cautious. 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. Potential renewed rise in infection cases and reintroduction of restrictions can significantly affect the current risk outlook.

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

1. Information regarding the survey carried out by the CSB of business confidence indicators in October is available in the CSB homepage: <https://www.csb.gov.lv/en/Statistics/covid19/Business-confidence-indicators-in-October> [↑](#footnote-ref-1)