International developments

Oil and raw materials

Oil prices are tumbling

Since summer 2014, oil prices have continued to fall, dropping from $111.80 (€82.20) per barrel in June to $78.40 (€62.90) in November, its lowest price since September 2010. This decrease is partly a result of the easing of tensions in the physical market, with less than robust demand and a supply which remains relatively abundant. In Q4 2014 and H1 2015, demand should grow slowly in a sluggish economic context. At the same time, average supply should continue to increase over the forecasting period: the decline in Q4 2014 should be more than offset by a rebound in Q1 2015.

The price per barrel, estimated at $70 for forecasting purposes, is nonetheless subject to various uncertainties: in a market where supply is outstripping demand, it may continue to fall in the short term. On the other hand, any supply outage from certain volatile producers (Iraq, Libya, Nigeria etc.) could push prices up again.

Oil prices have fallen since the summer

Since summer 2014 oil prices have continued to fall, dropping from $111.80 per barrel in June to $78.40 (€62.90) in November, its lowest price since September 2010 (*Graph 1*). Three factors explain this decline. Firstly, the increase in demand remains below 0.4 million barrels per day (Mbpd) as a quarterly average, the lowest rate seen since 2010. On average, the increase in supply has exceeded the rise in demand since summer 2013, propped up among other things by unconventional oil.

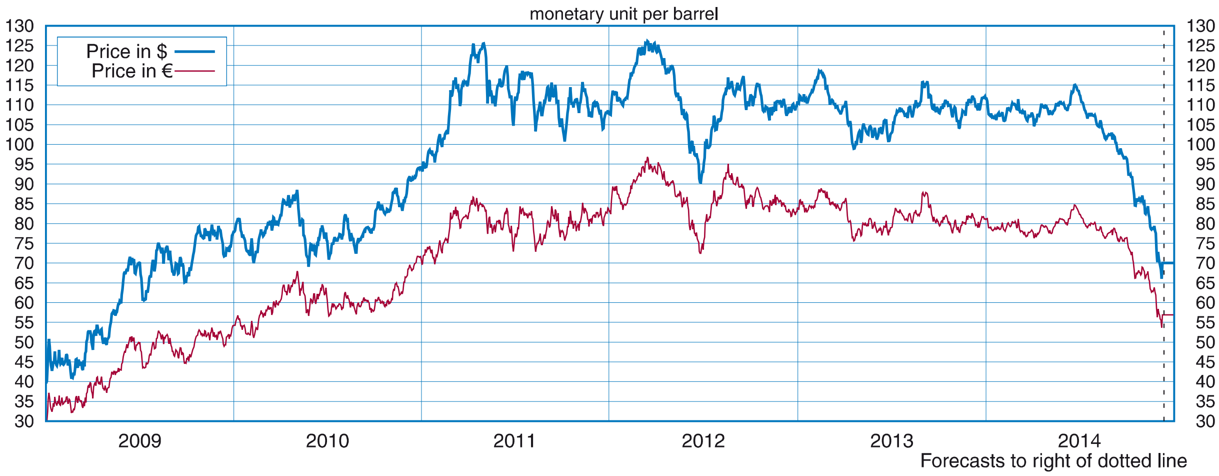
In addition to this easing of tensions in the physical markets, the fall in prices can also be attributed to the downgrading of forecasts for demand, particularly from China and the emerging economies, which appear to remain lastingly below the predictions made in H1.

A third factor is the easing of geopolitical tensions. As for the Ukrainian crisis, the reciprocal trade sanctions announced over the summer did not explicitly apply to energy products. Russia, in particular, has not reduced oil exports, which account for a significant share of national income. Furthermore, supply increased in Libya and Iraq in Q3, in spite of persistent geopolitical tensions.

Demand should increase slightly in Q4 2014 and H1 2015

In Q4 2014, demand should show a slight increase (+0.3 Mbpd, seasonally adjusted), in a global economic context which remains less than dynamic (*Graph 2*). Demand should fall in OECD nations, with a below-average increase expected in China. Thereafter, in H1 2015, demand should continue to grow at the same slow rate (+0.3 Mbpd per quarter), bolstered by China (+0.1 Mbpd) and other emerging economies (+0.3 Mbpd).

1 - Price of *Brent* in € and in $



Source: Macrobond

International developments

In Q4 2014, global oil production should fall slightly (-0.3 Mbpd on average over the quarter, seasonally adjusted), particularly in the OPEC nations (*Graph 3*). In Q1 2015, supply should recover significantly (+0.8 Mbpd), driven by American unconventional oil (+0.4 Mbpd) and natural gas liquids from the OPEC nations (+0.2 Mbpd). It should then slow in Q2 (+0.3 Mbpd); production should continue to increase in the United States (+0.2 Mbpd), while levelling out in the OPEC nations.

Brent crude prices should fluctuate around current levels ($70 per barrel)

For forecasting purposes, the price of a barrel of Brent crude has been formally set at its latest recorded price ($70 in early December 2014). Nevertheless, in a context of abundant supply and sluggish demand, the decline in prices could continue in the short term, although this decline should be attenuated by a number of factors.

Firstly, a price below $80 would not be sustainable in the medium-term for the majority of oil producers. On the one hand, the cost of non-conventional oil production in the USA exceeds $80 per barrel in certain output areas. On the other hand, the OPEC nations have set their budgets on the basis of higher forecast prices than current levels: faced with a persistent deterioration in prices, the cartel could end up reaching an agreement to reduce output in order to boost the barrel price.

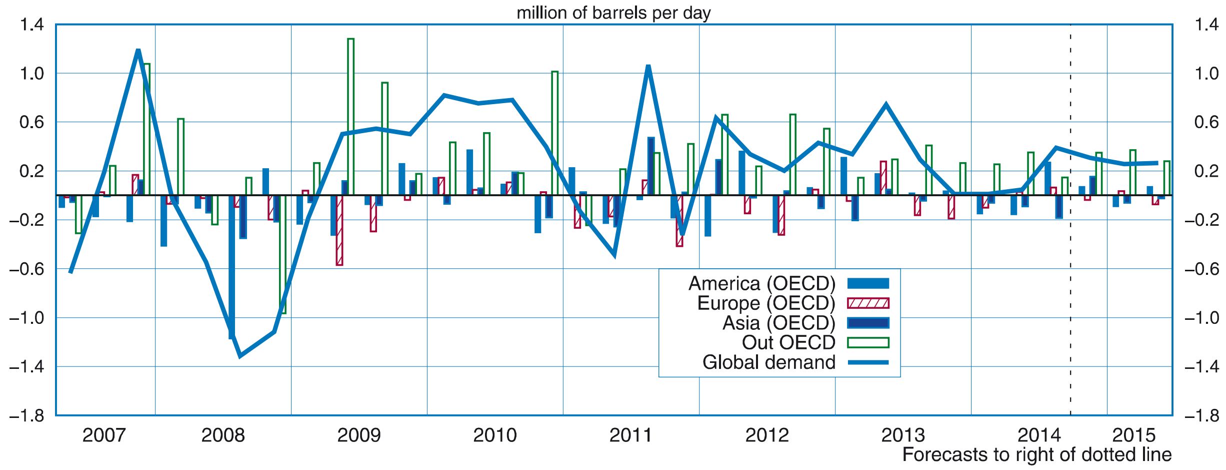
Furthermore, the restoration of production capacities in Iraq and Libya hinges upon geopolitical factors. Similarly, the international tensions generated both by the Ukraine crisis and the struggle to reach a definitive agreement over Iran's nuclear programme is likely to flare up again, therefore having a bullish effect on oil prices.

In Q3 2014, industrial commodity prices bounced back

Prices of non-energy commodities in euros increased by 5.0% in Q3 and in September 2014 hit their highest level since March 2013 (*Graph 4*). Agricultural raw materials, in particular, rose by 4.9% as a result of the strong increase in paper pulp and sawn softwood prices. Mineral prices also rose in Q3 (+5.9%). Prices of nickel rocketed at the end of the quarter: market operators are concerned that the Philippines may halt exports of the raw mineral with a view to developing a domestic processing industry, based on the Indonesian model.

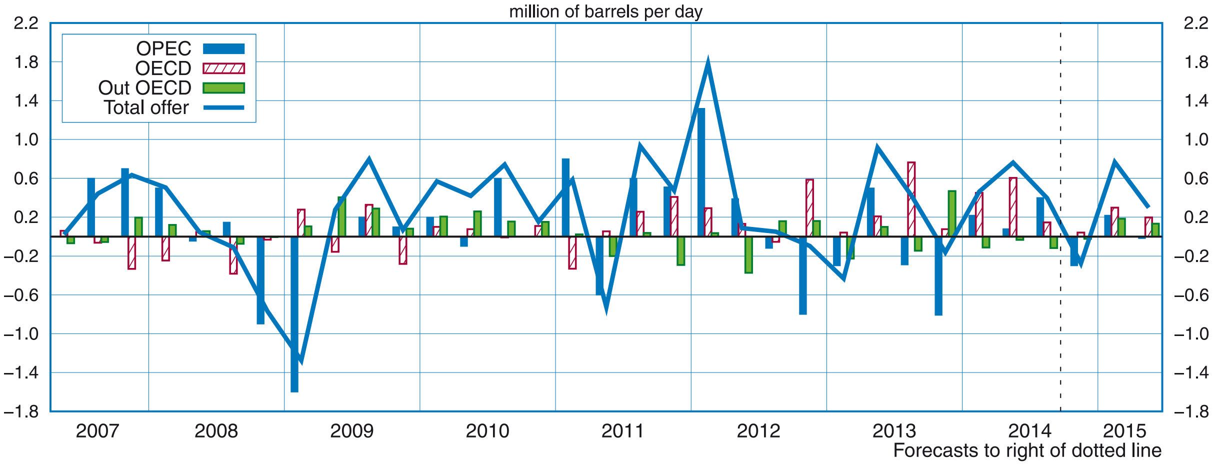
Prices of agricultural commodities also rose in Q3 (+4.1%), bolstered by the climb in the prices of oil seeds and tropical foodstuffs. This latter category rose sharply as a result of the increase in Arabica prices, spurred by fears of a drop in production in Brazil following a record drought.■

2 - Principal contributing factors to the variation in global oil demand



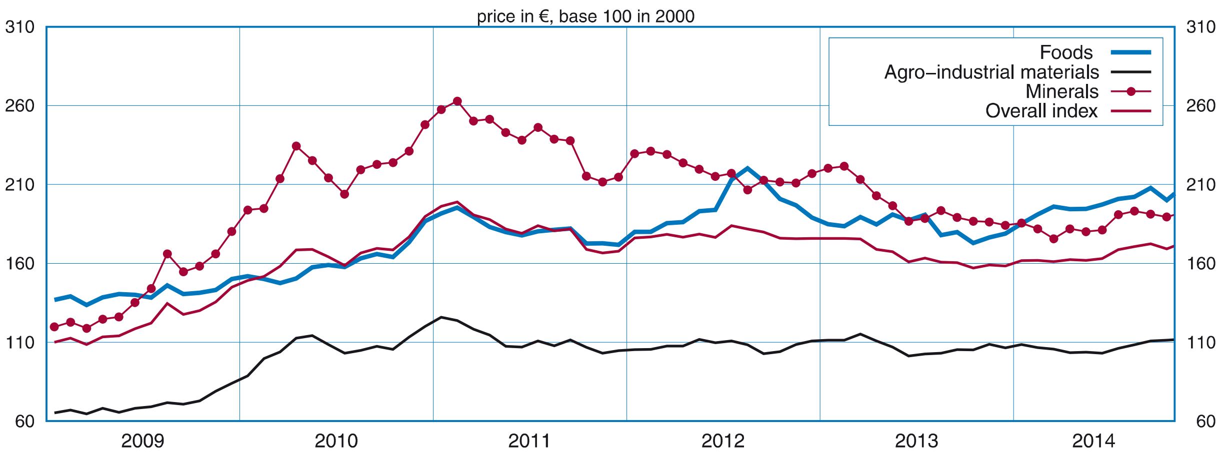
Source: AIE

3 - Principal contributing factors to the variation in global oil supply



Source: AIE

4 - Commodity prices



Source: INSEE

Financial markets

ECB and BoJ put their foot on the gas

After six years of non-standard monetary measures, the United States Federal Reserve has put an end to its quantitative easing program and is preparing to raise its base rate in response to the robust upturn in activity and the steady improvement seen on the labour market.

Meanwhile, in an effort to pull the country firmly out of its deflationary spiral, the Bank of Japan (BoJ) has announced an accelerated expansion of its monetary base. Furthermore the ECB, faced with weak inflation in the Eurozone, is beginning to implement the securities purchase programs and long-term refinancing operations announced in June and September.

These new measures are designed to stimulate the credit market, which remains lacklustre in the Eurozone. Sovereign debt financing conditions have further improved: in November 2014, Germany's ten-year yield hit 0.7% for the first time. At the same time, the Euro's depreciation against the dollar slowed after a marked fall over the summer.

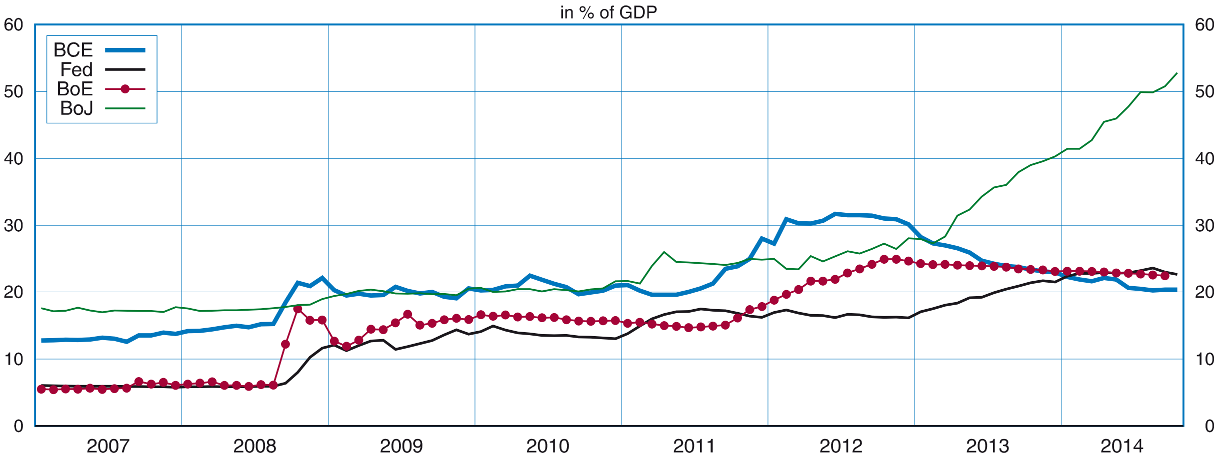
Over the forecasting period, the conventional assumptions for stable exchange rates against the Euro are: 1.23 dollars, 148 yen and 0.79 pounds.

Monetary policy returns to normal in the United States, but easing continues in the Eurozone

The Federal Reserve concluded its asset purchase program in October 2014, marking the end of the third cycle of quantitative easing and non-standard monetary policies launched in 2008. This change of direction had been widely anticipated, and has not created additional tension on the markets. The Fed's base rate remains unchanged at 0.25%, the last reduction dating back to September 2009. Any future change to this policy will be conditional upon a substantial overall improvement on the labour market - the Federal Reserve now takes into account the persistent sluggishness of the labour force participation rate, as well as the unemployment rate.

After a first reduction from 0.25% to 0.15% in June, the ECB cut its base rate back to 0.05% in early September. As previously announced, the central bank began buying up covered bonds issued by financial institutions in the autumn, as well as asset-backed securities, in order to boost the fluidity of the credit market. At the same time, the ECB has put in place targeted longer-term refinancing operations (TLTRO). The first round of these TLTROs, in September, did not meet with the level of success the bank had hoped for, compared

1 - Balance sheets of the main central banks
Last point: November 2014



Source: Central Banks

with what the European banks could have been expected to borrow. Moreover, the banks used some of the funds from these TLTROs to pay off ahead of schedule those outstanding LTROs due for payment by the end of 2014. After discounting these early repayments, the long-term refinancing operations have allowed the ECB to increase its balance sheet by around €40 billion, moving towards the declared target total of €1000 billion for all measures (*Graph 1*).

In Japan, the expansionist monetary policy initiated in early 2013 in an effort to put an end to deflation has led to substantial depreciation of the yen (down 22% between December 2012 and January 2014), and an accompanying increase in imported inflation. Inflation has also risen as a result of the increase in VAT in April. Although substantial, this increase in inflation is deemed to be insufficient (+2.9% in October 2014 although, according to the BoJ, it would be equal to +1.0% without the VAT rise) and Japan once again entered into recession in Q3. In late October the central bank announced an accelerated expansion of its monetary base, at a rate of ¥80,000 billion per year (approx. 15% of annual GDP), up from ¥60,000 - ¥70,000 billion previously.

In the United Kingdom, the Bank of England maintained its base rate of 0.5% and continues to hold a substantial - albeit unchanged since 2012 - stock of government bonds (£375 billion, equivalent to around 20% of GDP), the interest on which is paid back to the Treasury.

Demand for credit remains sluggish in the Eurozone

The latest measures taken by the ECB should help to stimulate the lending market, which has continued to stall, partly as a result of sluggish demand as private agents outside the financial sector continue to reduce their levels of debt. This contraction of lending among businesses in the Eurozone - manifested by a reduction in the volume of outstanding loans which has been particularly strong in Italy, and especially in Spain - continued in Q3 2014, albeit at a rate slightly below that seen at the end of 2013 *(Graph 2*). Outstanding loans even increased slightly in France and Germany.

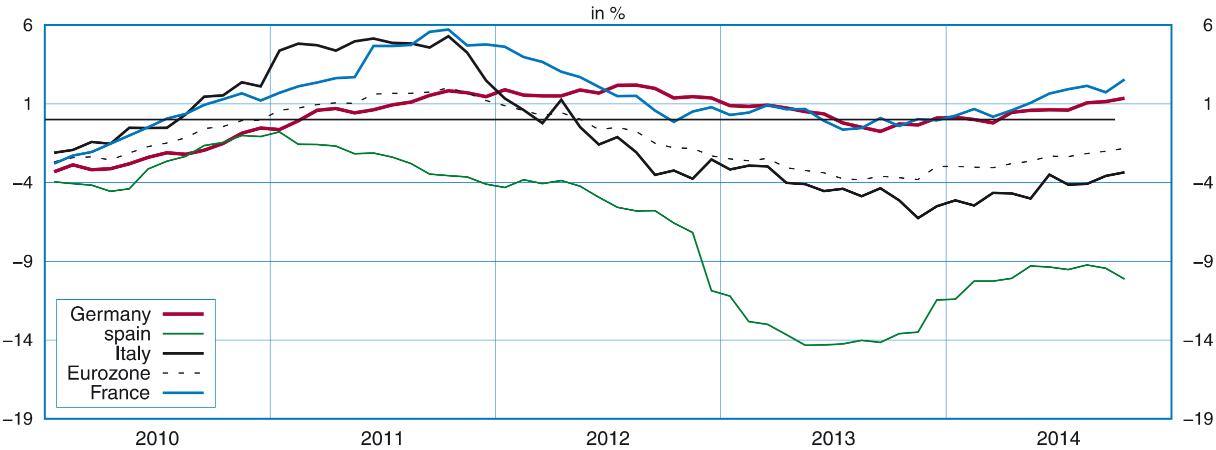
German and French sovereign yields continue to fall

Germany and France are enjoying increasingly favourable financing conditions, while American and British sovereign yields have fallen slightly since the start of the year (*Graph 3*). Meanwhile, most of the countries affected by the sovereign debt crisis of 2011 now once again have access to more favourable financing conditions: Spanish and Italian ten-year bond yields have continued to fall (in early December 2014 they stood at around 1.8% and 2.0% respectively), while Portugal has made its return to the bond markets. On the other hand, the Greek situation is apparently still a cause for concern for the markets.

Euro falls on ECB announcements

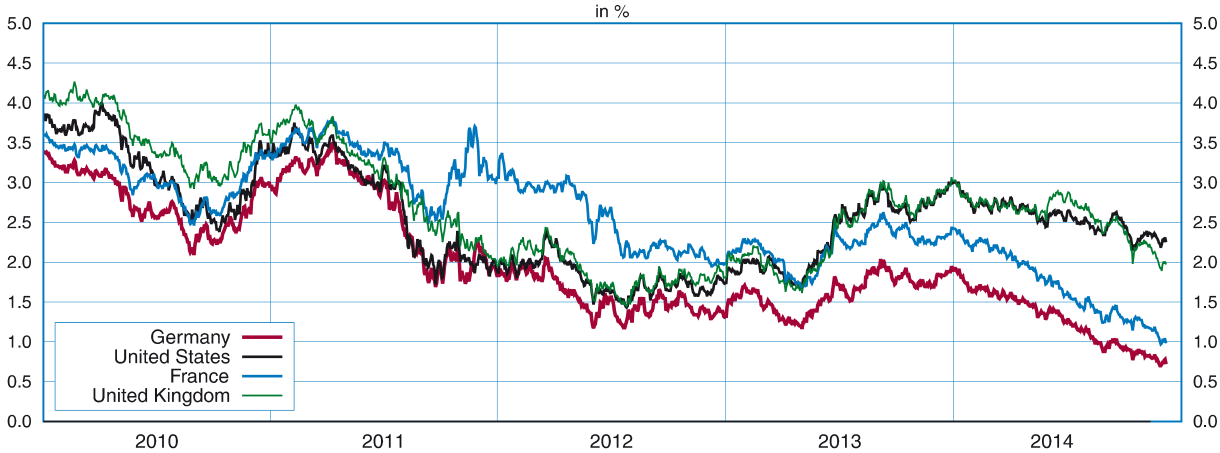
Following the announcement of further easing measures by the ECB, the euro began to fall against the pound and the dollar (*Graph 4*). In early December the exchange rate stood at around 1.23 dollars to the Euro. Meanwhile, the announcement by the Bank of Japan of its intention to accelerate money creation saw the value of the yen fall. Furthermore, the Chinese authorities have allowed the yuan to appreciate again since June. By early December it had returned to its April 2014 value.?■

2 – Annual growth of the volume of outstanding loans to non-financial corporations in the Eurozone
Last point: October 2014



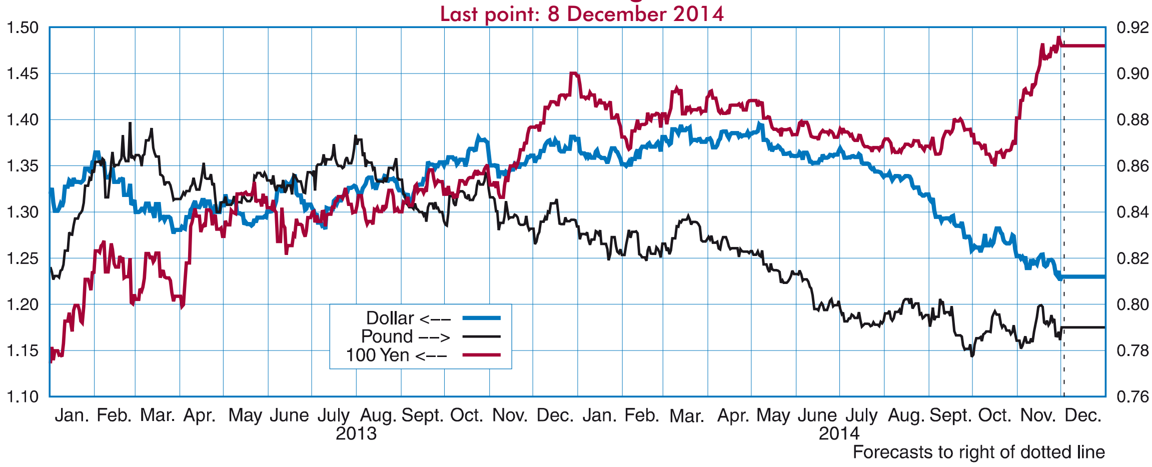
Source: EuropeanCentral Bank

3 - Ten-year sovereign yields
Last point: 8 December 2014



Source: Macrobond

4 - Euro exchange rate
Last point: 8 December 2014



Source: EuropeanCentral Ban

Stress tests and the Banking Union strengthen the Eurozone banking sector

The European sovereign debt crisis highlighted the problems that resulted from close links between public finance and the banking sector: States had to recapitalise or guarantee the debts of certain banks following the 2008 crisis, thereby damaging their own financial situation; the balance sheets of banks that, in some countries, are major creditors of States, were then weakened in turn. To escape from this vicious circle, Member States have put in place the European Stability Mechanism (ESM) to assist States in difficulty. In parallel with this, governments agreed in June 2012 to create a Banking Union to complement the Economic and Monetary Union and ensure centralised supervision of banks in the Eurozone (and in any non-Eurozone Member State wishing to be included in the system).

The Banking Union should mean that banks' credibility depends more on their own specific risk profile and less on the financial solidity of the Member State in which they operate. Finally, the aim of the Banking Union is to ensure the sustainable stability of the banking sector in the Eurozone.

The Banking Union is a 3-pillar system

The first pillar of the Banking Union is the Single Supervisory Mechanism (SSM). Since 4 November 2014, the ECB has been responsible for the direct supervision of the 130 largest banks in the Eurozone. Before this, all banks were under the responsibility of national supervisors, who now only retain direct supervision over the remaining banks (with the ECB ultimately responsible for supervision). Prior to the SSM, the

ECB launched a quality review of banks' assets complemented with stress tests carried out by the European Banking Authority (EBA).

The second pillar of the Banking Union concerns the resolution of banking crises. The Single Resolution Mechanism (SRM) will implement at Eurozone level the common European framework to resolve banks that are failing (BRRD directive), limiting the cost to taxpayers and to the real economy. Within this framework there will be a bail-in resolution mechanism ensuring that bondholders pay a contribution.

Lastly, the third pillar of the Banking Union would be the set-up of a deposit guarantee fund. Since 1994, a European directive has ensured basic protection for bank deposits. In 2009, a new directive imposed a gradual harmonisation of the amounts to be guaranteed, set at €100,000 at the end of 2010. The last step would be to set up a mutual fund at European level (still under negotiation).

Prudential rules

The setting up of the SSM follows on from the transposition into European law («CRD IV» package) of the Basel III international accords of 1st January 2014. This gives the definition of the core capital (Common equity Tier 1 i.e. ordinary and assimilated shares), and the CET1 ratio, a ratio of core capital to risk-weighted assets (RWA); this ratio must always be at least 4.5%, to which is added a capital conservation buffer of 2.5%. Thus the CET1 ratio should normally be higher than 7%. When a bank's capital conservation buffer falls below 2.5%, its profit distribution will be limited to enable it to rebuild this safety cushion. In addition to these requirements relating to capital, a leverage ratio has been put in place, liquidity management has been improved and supervisory requirements relating to certain risks have been strengthened.

Prior to taking up its supervisory role for the largest banks in the Eurozone, the ECB carried out a comprehensive quality review of their balance sheets (AQR) and the EBA carried out stress tests.

Assessment of banks' balance sheets

The assets of the 130 banks assessed totalled €22,000bn on 31 December 2013, which represents 82% of total bank assets and about 2.2 times the GDP of the Eurozone. The scope of the assessment included the main banks in the Eurozone (assets over €30bn, 20% of GDP of country of origin, or if the bank is one of the three largest credit establishments in the country); this is slightly larger in scope than the 2011 tests (which covered only 90 banks throughout the European Union).

The Asset Quality Review (AQR) ensured in particular that the classification of non-performing loans (any bond that was 90 days overdue, depreciated or in default) was harmonised and monitored. In all, a further €136bn of non-performing exposures were identified (*Graph 1*): €55bn via harmonisation of criteria and €81bn via the credit file review.

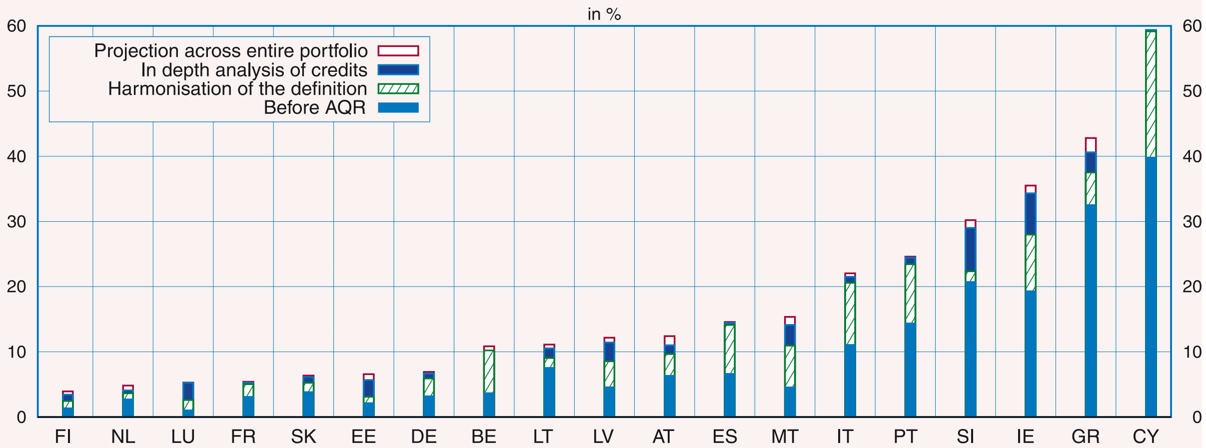
Exposure to non-performing loans was revised upwards for all the countries studied. The order of the countries remained the same, overall, before and after the AQR: the countries of southern Europe and Ireland were most exposed to doubtful credit. However, the exposure of some countries like Belgium and Spain was revised more strongly upwards following harmonisation of the definition.

Stress tests

Within the same framework, the EBA conducted stress tests on the 130 banks in the Eurozone in the scope of the AQR. These tests are based on hypotheses of activity below the baseline scenario of 2.2% in 2014, 5.6% in 2015 and 7.0% in 2016 and hypotheses of unemployment greater than that of the baseline scenario of 0.6 points in 2014, 1.9 points in 2015 and 2.9 points in 2016. However, the stress tests were not applied under the hypothesis of deflation in the Eurozone.[1]

(1) In the baseline scenario, inflation in the Eurozone was estimated to be 1% in 2014, 1.3% in 2015 and 1.5% in 2016. In the adverse test scenario, inflation fell to 0.6% in 2015 and 0.3% in 2016. The current forecasts fall short of these levels (see *report, "There is a risk of negative inflation but it does not necessarily signal deflation"*).

1 - Share of non-performing loans after the AQR



Source: European Central Bank

To pass the tests, banks had to demonstrate a CET1 ratio higher than 8% following the AQR and a ratio higher than 5.5% after an adverse scenario. However, the tests did reveal heterogeneity in the reactions to the scenario by the different countries (*Graph 2*). For example, despite an equivalent CET1 ratio in Portugal and France, the French banks would demonstrate a much better resilience to the test scenario than the Portuguese banks, which would fall down close to the 5.5% limit.

Capital shortfall in 25 banks

Ultimately, out of 130 banks studied, 25 did not achieve the goal of a CET1 ratio higher than 5.5% and there was a total shortfall of capital of €25bn if the ratios imposed according to the SSM were to be respected (*Graph 3*). Of this total, there was a €10bn shortfall for Italian banks and almost €9bn for Greek banks.

However, half of the aforementioned banks had already covered their capital shortfall before the test results were published and the 12 remaining banks now need to raise just under €10bn capital in all.

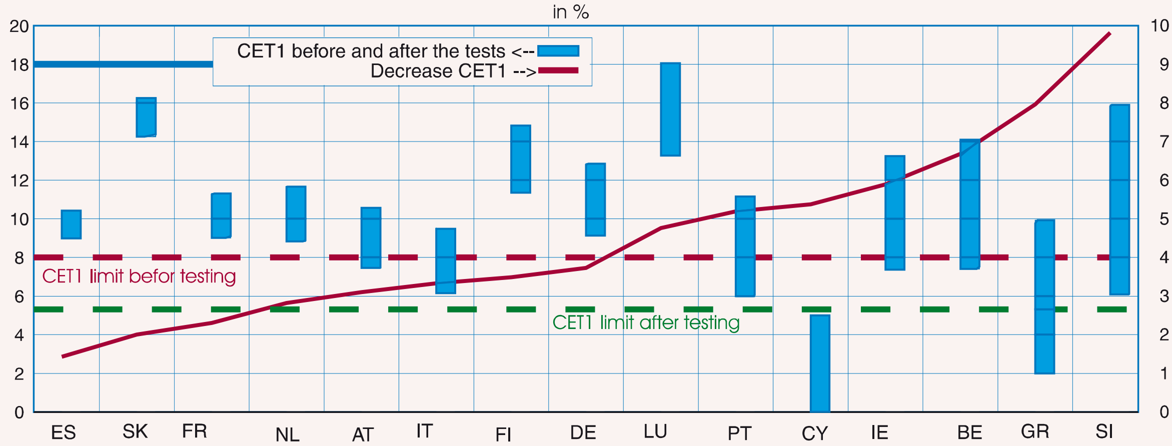
The AQR enabled banks to restructure their balance sheets

Overall, the outcome of the exercise was positive and did not result in any strong reactions from the markets: share prices for the banks that passed the tests remained stable. The review of the banks' assets helped them strengthen their balance sheets. To increase their solvency ratios and adapt to the new regulatory requirements, they raised capital or sometimes had to sell assets and debt portfolios.

Most of the banks demonstrated their resilience and eliminated any uncertainty surrounding the financial health of their balance sheets, with the result that any doubts about their ability to grant credit have been removed. The ECB hopes for a ramp-up of the TLTRO. There are also hopes of an improvement in the credit market in the countries where credit is down despite the banks having been proved to be solid; Spain in particular is a case in point. In contrast, the weakness of the Italian banks, as highlighted by this assessment, may account for their reticence to grant credit and does tend to reinforce the sluggishness of investment in Italy. ■

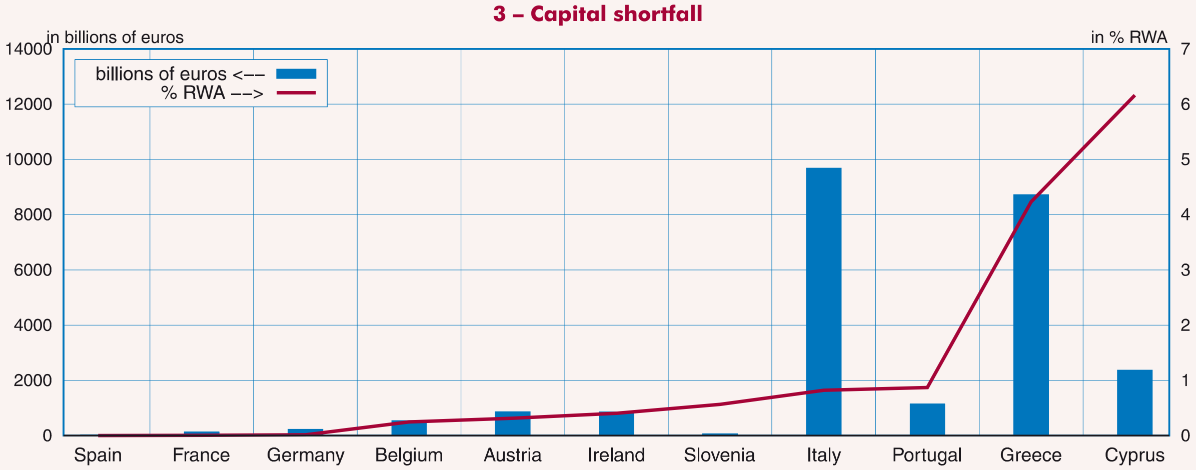
2 - Impact of stress tests on CET1

in %



Source: European Central Bank

3 – Capital shortfall



Source: European Central Bank

Eurozone

A break in the clouds

In Q3 2014 GDP grew in the Eurozone (+0.2%, as predicted in October's Conjoncture in France report), primarily as a result of the dynamism of the Spanish (+0.5%) and French (+0.3%) economies, while the results from Germany proved to be disappointing (+0.1%).

The persistently low level of the business climate indicator between June and October suggests that activity will continue to grow at this slow rate in Q4 (+0.2%), as the widespread caution exhibited by businesses means there will be no upturn in investment.

In early 2015, activity should pick up pace (+0.4% in Q1), stimulated by the creation of a minimum wage in Germany and the return to normal levels of energy spending, particularly in France; activity should then grow by 0.3% in Q2 2015, galvanised by the gradual attenuation of the construction crisis in Spain and France.

Overall growth in the Eurozone should reach +0.8% in 2014, with a growth overhang of +0.9% at the end of Q2 2015.

In Q3 2014 the Eurozone economy grew by 0.2%

In Q3 2014, GDP increased again in the Eurozone (+0.2% after +0.1%). Spain (+0.5%) and France (+0.3%) were the primary contributors to this growth, while activity saw only limited growth in Germany (+0.1%) and declined once again in Italy (-0.1%). Household consumption, particularly robust in Germany and Spain, was the main driving force behind the upturn in demand (+0.5% in the Eurozone). On the other hand, investment decreased again (-0.2% after -0.6%): the decline continued in the construction industry, particularly in Spain, Italy and France, and spending on equipment suffered as a result of the uncertain outlook in the industrial branches, where a general atmosphere of cautiousness prevails.

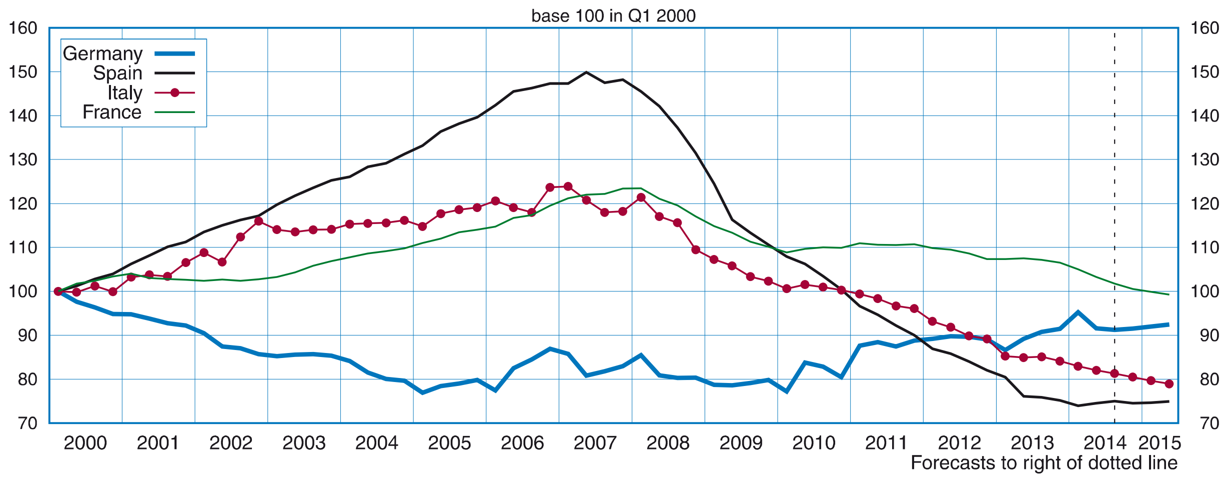
Business tendency surveys suggest that growth will remain modest in Q4 2014

From July through to October the results of the business tendency surveys deteriorated throughout the Eurozone, with the exception of Spain. Although the outlook in the principal Eurozone economies did pick up in the November survey, the business climate indicators suggest that activity will continue to grow at a modest rate in the final months of the year. Growth should thus stand at +0.2% for Q4 2014. In terms of demand, investment in production capacities should remain sluggish and consumption should slow in both Germany and France.

Activity should pick up pace again in early 2015, stimulated by the introduction of a minimum wage in Germany

In Q1 2015, GDP should grow more rapidly (+0.4%) as a result of more robust domestic demand. Consumption should be galvanised (+0.5%) by the return to normal levels of spending on heating, particularly in France (rebounding from a significant decrease towards the end of the

1 - Construction investment in the Eurozone



Sources: National accounts, Eurostat, INSEE calculations year). Furthermore, activity in Germany should be catalysed by the introduction of a minimum wage and the implementation of new measures designed to boost household income. In spite of the partial dissipation of these short-term factors, consumption should remain dynamic in Q2 (+0.4%), stimulated by the gradual recovery of household purchasing power as a result, depending on the national context, of an upturn in employment or a more favourable tax policy.

Meanwhile, investment should pick up gradually. For businesses, investment in production capacities should increase very slightly as a result of the modest improvement in anticipated demand and the recent increase in the production capacity utilisation rate. In both Spain and France, the phase of adjustment in new housing construction should be virtually over by mid-2015, allowing investment in construction to stabilise across the Eurozone as a whole (*Graph 1*).

Exports and imports should increase at the same pace

Despite the moderate growth of global demand, the recent depreciation of the Euro should serve to galvanise exports (+1.0% per quarter). However, against the backdrop of a gradual recovery of domestic demand, imports should also show progress (+0.9% in Q4 2014, then +1.0% in the first two quarters of 2015). All in all, the contribution of foreign trade to growth should therefore be slightly positive.

Inflation should stay low

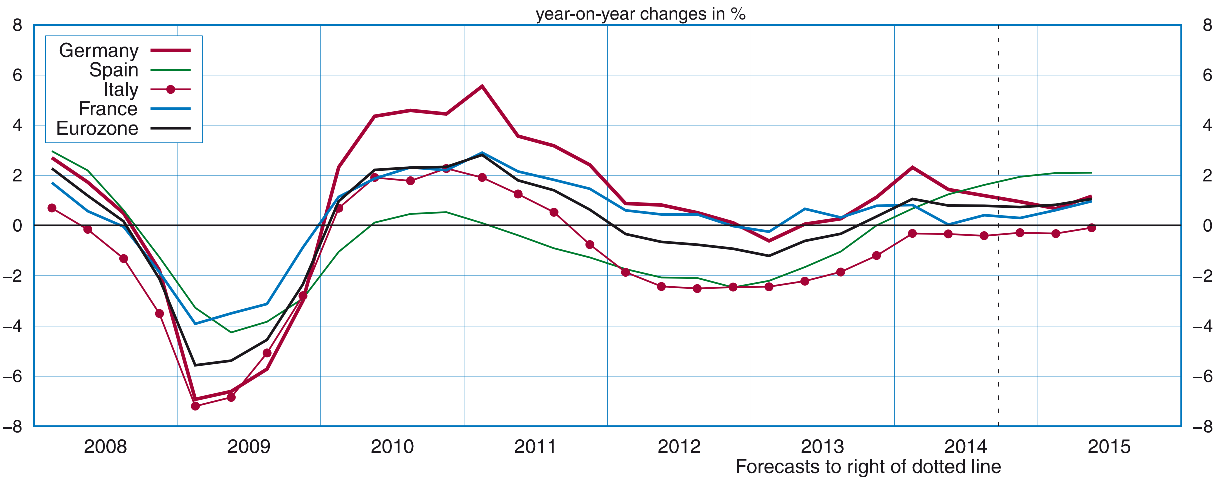
In November 2014, year-on-year inflation across the Eurozone as a whole stood at +0.3%, according to a provisional estimate. This figure should fall to 0.1% by June 2015. Indeed, based on the assumption that the price of a barrel of Brent crude remains stable at $70 (€56.90) over the forecasting period, and as the year-on-year effects of the increases observed in Q2 2014 cease to be felt, the fall in the price of energy products should gather pace (-4.1% year-on-year in June 2015, after -2.5% in November 2014). Nonetheless, this fall should be partly offset by a further increase in food prices. Moreover, with inflationary pressures limited by an unemployment rate which remains high in the majority of Eurozone countries, core inflation should remain subdued: standing at +0.5% for the year in June 2015, down from +0.7% in November 2014, this figure should thus hit its lowest level since records began (1996).

Three very different scenarios within the Eurozone

The outlook for activity in the Eurozone illustrates the three different models of recovery which we should see in early 2015 (*Graph 2*): a dynamic recovery in Spain, where companies are beginning to renew their production capacities, particularly through investment; a more modest recovery in France and Germany, the countries which have seen the smallest decrease in investment since 2008 and where investment will remain subdued; and finally the absence of a recovery in Italy, where the decline in investment, in both construction and equipment, should continue to weigh heavily on the economy in H1 2015.

As an average for 2014, growth in the Eurozone should stand at +0.8% (after -0.4% in 2013), with a growth overhang of +0.9% at the end of Q2 2015.■

2 – Real GDP growth in the Eurozone



Sources: National accounts, Eurostat, INSEE calculations