Financial markets

Stock market turmoil is not holding back a dynamic financial market

The central banks are seeking to gradually scale back their accommodating monetary policies without hampering economic growth. The Federal Reserve raised its base rates in December 2017 and is expected to raise them three or four more times in 2018, reassured by American inflation settling around its target of 2% and a still very buoyant labour market. The European Central Bank (ECB) is extending its quantitative easing programme until September 2018, but halved its asset purchase programme from January 2018 onwards.

The credit situation continues to improve across the entire Eurozone, although with some disparities: outstanding loans to the non-financial private sector, enterprises and households are stable in Spain, but rising strongly in France and Germany. Outstanding loans in France are distinctly more buoyant than in its neighbouring countries, with equivalent interest rates for enterprises and lower rates for households. European banks are expecting to stabilise their credit terms after easing them recently. The proportion of non-performing loans is declining.

The euro has been appreciating against the dollar since January 2017, topping $1.24 in January 2018 with the improvement in the economic outlook in Europe, before slipping back in February and stabilising at about $1.23.

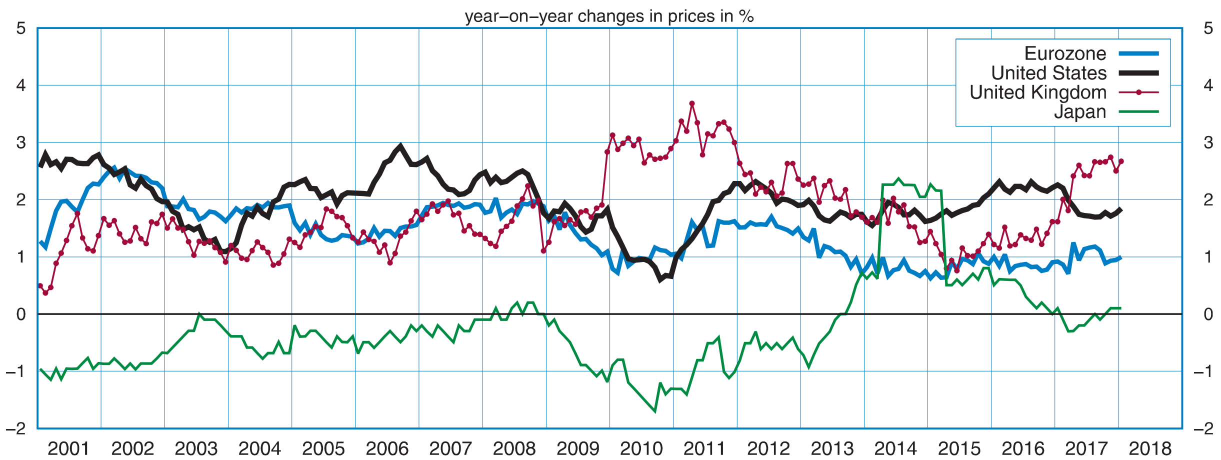
The real effective exchange rate rose strongly for French exporters in Q3 2017 before stabilising in Q4. By convention, the euro exchange rate is fixed in the forecasts at 1.23 dollars, 0.87 pounds sterling and 135 yen.

The Fed cautiously normalises its monetary policy

The Fed raised its base rates in June and December 2017 and is expected to raise them again three or four times in 2018. It is also speeding up measures to reduce its balance sheet, which currently stands at to $4,400 billion, at a rate of $20 billion a month since January 2018. The scale of this reduction will gradually intensify until it reaches $50 billion a month by the end of 2018. The Fed has been encouraged to pursue this policy by the drop in unemployment to 4.1% and by dynamic inflation – both headline and core – that is close to the target of 2% (*Graph 1*).

Although the appointment of Jerome Powell, the new Chairman of the Board of Governors of the Fed, replacing Janet Yellen, does not seem to indicate a dramatic change in short-term monetary policy, the forthcoming replacement of three governors out of seven is likely to alter the direction of American monetary policy.

1 - Core inflation in the world



Sources: Eurostat, BLS, JSB, ONS

The ECB reduces its accommodating monetary policy

Meanwhile, in January the Central European Bank (BCE) confirmed that it is prolonging its accommodating policy and extending its asset purchase programme at least until September 2018. But it has publicly remarked on the "stronger than expected" acceleration in economic activity in the Eurozone, strengthening expectations of a gradual end to quantitative easing. Core inflation remains close to 1%, below the target of 2%. Base rates remain at a historically low level: the deposit facility rate has stood at –0.40% since March 2016 (*Graph 2*). The Governor of the ECB, Mario Draghi, has announced that the three base rates would remain at their current levels for "an extended period (…) well beyond" the end of the securities purchase programme. This programme will be maintained until at least September 2018, although at a more moderate rate: €30 billion a month from January 2018, instead of €60 billion until now.

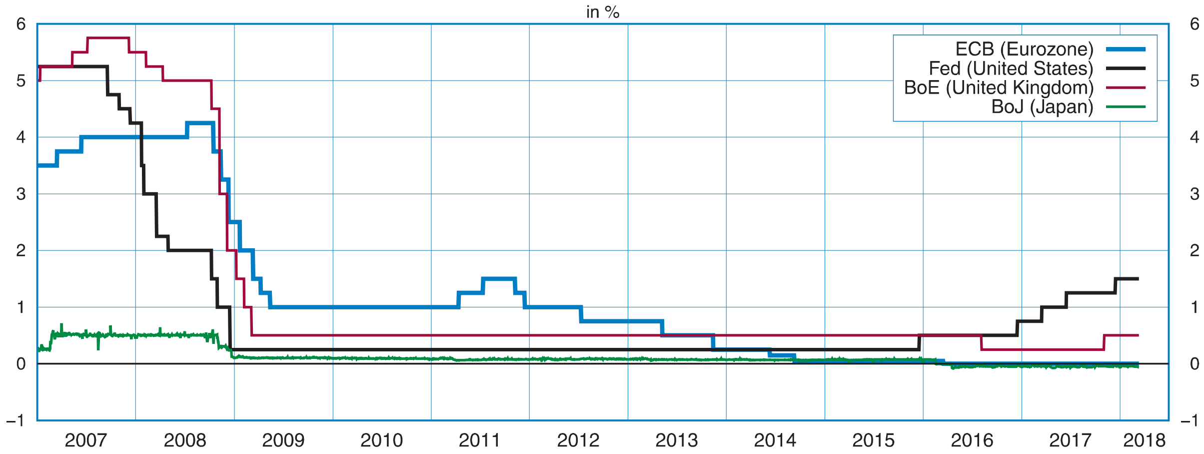
European and American sovereign yields are increasing

The sovereign yields of the advanced countries grew fast in January 2018 under the effect of the expected gradual end to accommodating monetary policies. They do not seem be suffering from the uncertainties linked to the political crisis in Catalonia, the more difficult than expected process of forming a government in Germany and the Italian elections. Spreads are decreasing slightly: the France-Germany spread is hovering around 30 basis points, while the Italy-Germany spread has been reduced to about 130 basis points, compared to the 200 recorded in Q1 2017.

Credit is very buoyant in the Eurozone, especially in France

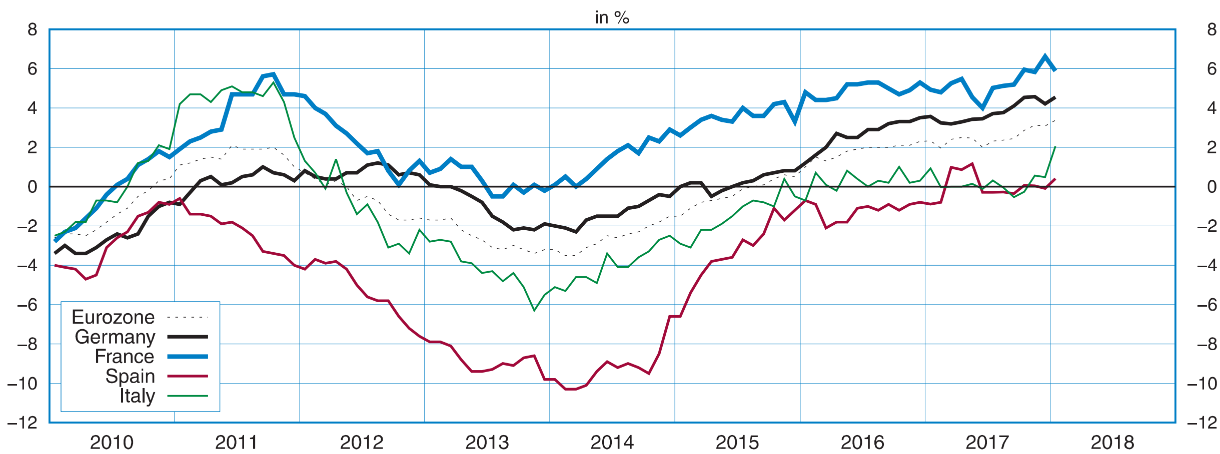
Credit terms continue to be very favourable overall in the Eurozone, with some disparities between countries. Outstanding loans to non-financial corporations in the Eurozone continue to rise (*Graph 3*): in January 2018, their year-on-year

2 - Base rates of the main central banks



Sources: Fed, ECB, BoJ, BoE

3 - Annual growth rate of outstanding corporate loans in the Eurozone



Source: ECB

growth reached +5.9% in France after +6.6% in December 2017 and +4.5% in Germany after +4.2%. They are increasing again in Italy (+2.1% after +0.5%) and in Spain (+0.4% after –0.1%). The interest rates charged to enterprises are stabilising in the four large countries: they are fluctuating around 1.5% in Germany, France and Italy and around 2% in Spain.

France stands out from its main European partners when it comes to household lending, with a lower interest rate and more a vigorous situation as regards outstanding loans: the annual rise in these outstanding loans reached +5.9% in January 2018 compared to +2.9% for the Eurozone as a whole. This trend does not seem to be adversely affected by the slight increase in the rates on new loans to households.

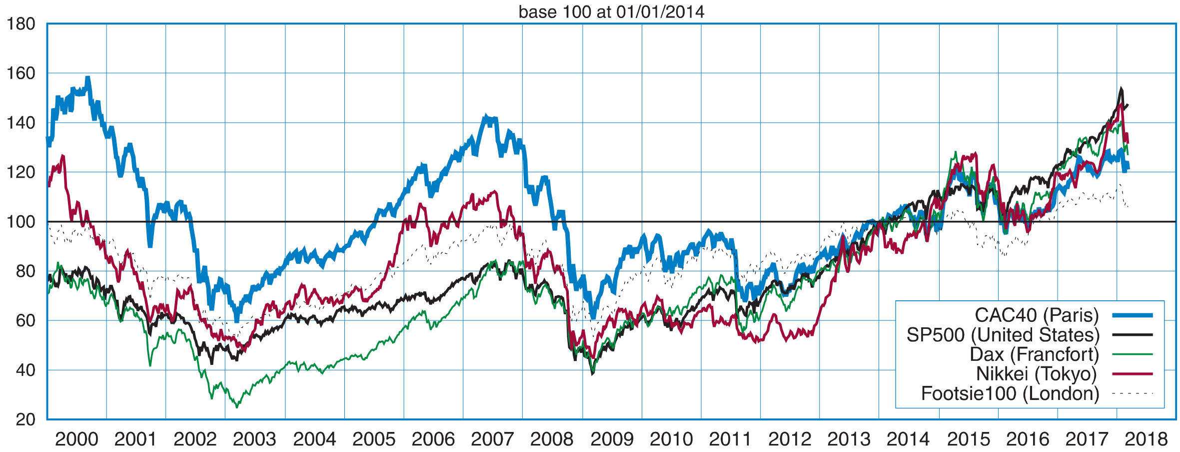
Stock markets were on an upward trend until a market correction in early February 2018

Low interest rates and a favourable economic outlook took stock market indices to historically high levels at the end of January 2018, with volatility at historically low levels. At the beginning of February 2018, a higher than expected increase in wages in the United States led to a correction of stock market indices and a sudden increase in volatility, with investors expressing alarm at the inflationary risks in the United States and rising interest rates (*Graph 4*).

The euro appreciated in January 2018

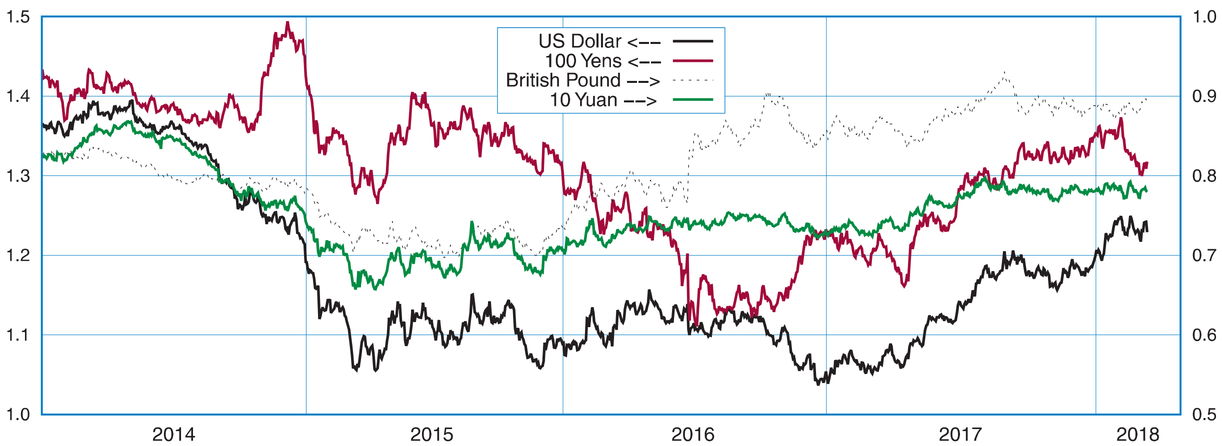
In 2017 and in January 2018 the Euro appreciated significantly against the dollar and other currencies (*Graph 5*), driven by favourable economic

4 - Stock market indices of the advanced countries



Source: DataInsight

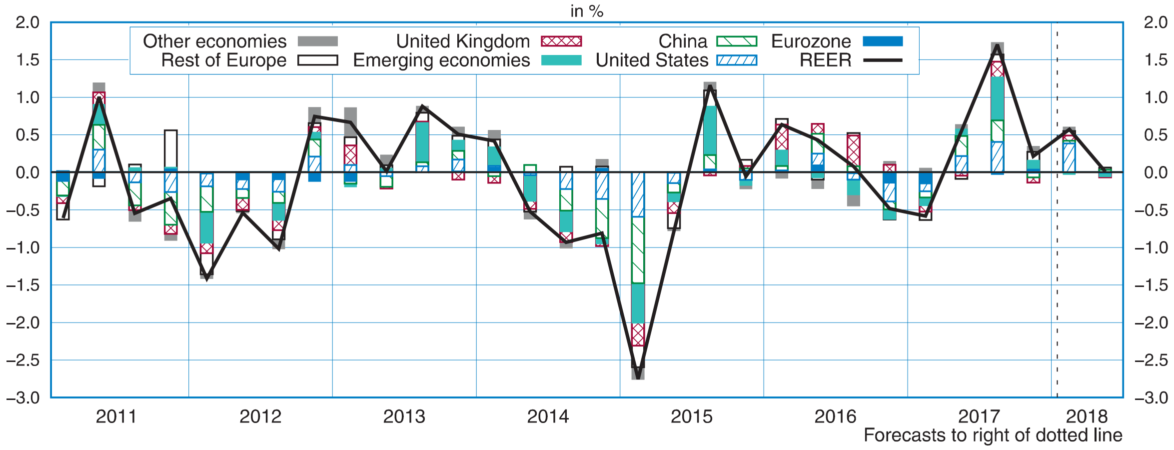
5 - Ten-year European sovereign yields



Source: DataInsight

prospects. This led to a sharp increase in the real effective exchange rate for French exporters in Q3 2017(+1.7%), as well as in Q1 2018 (+0.5% expected, *Graph 6*). At the beginning of February, the euro depreciated slightly due to a rise in interest rates and the stock market correction and is now hovering around the $1.23 mark. By convention, the exchange rate of the euro has been set at £0.87, ¥135 and $1.23 through to the end of the forecasting period. ■

6 - Quarterly change in real effective exchange rate (REER) of France and its contributing components



Sources: Banque de France, National statistical institutes, INSEE calculations