Financial markets

Monetary policy: America first

The directions monetary policies are taking continue to diverge on either side of the Atlantic. On the one hand, the US Federal Reserve raised its base rates in December, encouraged by core inflation exceeding its 2% target and by low unemployment. The Fed plans to raise them three more times in 2017. On the other side of the Atlantic, core inflation remains moderate in the Eurozone and the European Central Bank is continuing its accommodating monetary policy. It will extend its asset purchase programme beyond March 2017, albeit at a reduced scale.
European sovereign yields are rising again and the spreads between them are widening. The credit market continues to improve in the Eurozone, even though credit is rising considerably less quickly than the monetary base. Contrasting situations persist between European countries: outstanding loans to enterprises are growing steadily in France and Germany while they are still falling in Italy and Spain.
Following the election of Donald Trump and the rise in the Fed's base rates, the dollar appreciated against the Euro at the end of 2016; the pound and the yen have stabilised, so much so that the French real effective exchange rate has slipped back a little. By convention, the Euro exchange rate is fixed in the forecasts at 1.06 dollars, 0.87 pounds sterling and 120 yen.

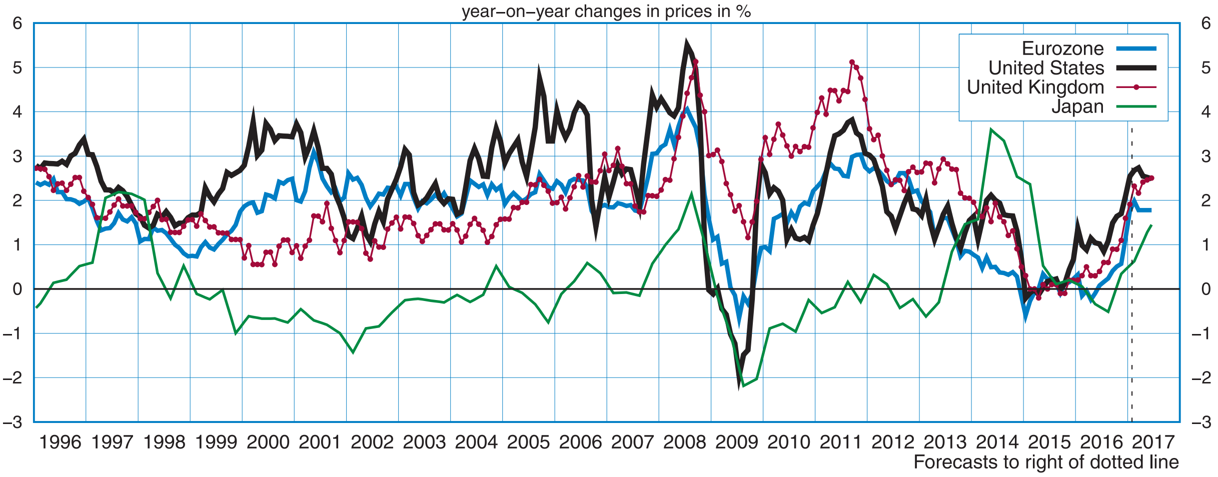
The Federal Reserve raised its base rate in December and is expected to raise it again in 2017

In December 2016 the American central bank (the Fed) raised its base rate from 0.50% to 0.75%. The last time it was raised was in December 2015. The Fed's objectives have been met: the unemployment rate has stabilised at a low level (4.8% in January), and core inflation has remained anchored above the 2% threshold since January 2016. Headline inflation has been increasing since mid-2016 due to the energy component (*Graph 1*); at the beginning of 2017, energy is expected to catch up with and even move slightly ahead of the core component. As a result, the Fed is expected to continue normalising its monetary policy by gradually increasing its base rates, with three increases planned in 2017.

The ECB is expected to slow its accommodating monetary policy slightly

For its part, the European Central Bank (ECB) announced in December 2016 that it would be extending its accommodating policy beyond March 2017. In the Eurozone, core inflation indeed remains moderate, well under 2% (*Graph 2*). However, from April, the ECB will reduce the amount of its securities purchases on the secondary market to 60 billion Euros a month,

1 - Inflation in the world



Sources: Eurostat, BLS, JSB, ONS

from 80 billion Euros previously. Base rates have been maintained at a historically low level: the deposit facility rate has been –0.40% since March 2016.

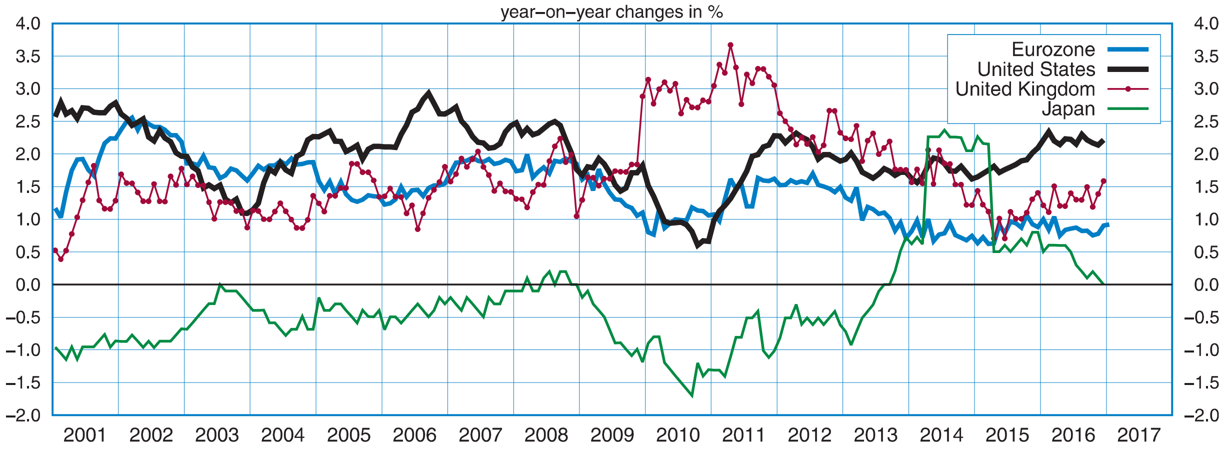
European sovereign yields have picked up and spreads have widened

The sovereign yields of advanced countries have risen since Donald Trump's victory and the increase in the Fed's base rates. At the beginning of March, the French 10-year yield stood at about 1.0% after reaching a low of 0.2% in July 2016 (*Graph 3*). The Spanish and Italian sovereign yields have also increased sharply while the German 10-year yield has seen a moderate upturn. The spread between French and German sovereign yields has increased, reaching up to 70 basis points. The Italian-German spread has reached 200 basis points. This new divergence is explained by high outflows of private capital from Italy. The spreads within the Eurozone nevertheless remain lower than they were between 2011 and 2013.

Lending to enterprises has picked again up in the Eurozone, except in Italy and Spain

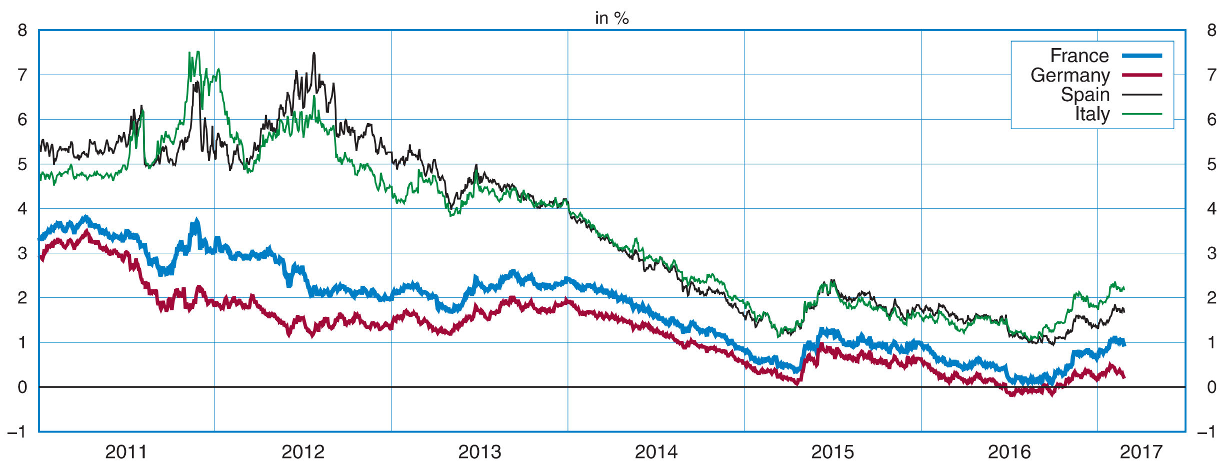
Outstanding loans to non-financial corporations in the Eurozone have been rising since January 2016, continuing the improvement that began at 2014. Over one year to January 2017, outstanding loans increased by 1.7%. This upturn in credit nonetheless remains modest in light of the strong growth in the monetary base implemented by the ECB. The quantity of excess liquidity that the banks are leaving in reserve with the ECB therefore continues to swell (*Graph 4*). Outstanding loans to

2 - Core inflation in the world



Source: Eurostat, BLS, JSB, ONS

3 - Ten-year European sovereign yields



Source: Macrobond

non-financial corporations are buoyant in France (+4.5% year-on-year to January 2017) and in Germany (+4.4%). However, they have fallen again, by around –0.7%, in Spain and Italy. Interest rates on new loans have converged between the Eurozone countries (to around 1.5%), except in Spain where they remain higher (2.0%). The credit market easing cycle is likely to be drawing to a close at European level, in the wake of the rise in sovereign yields, according to the ECB's latest surveys of private banks on the credit issue.

In early 2017 stock market indices are stabilising after picking up at the end of 2016

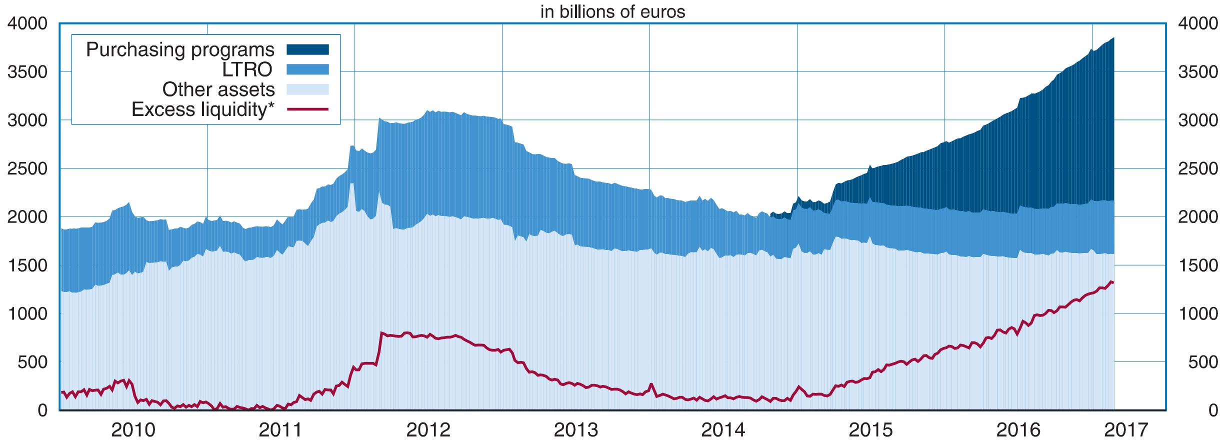
The stock market indices of the advanced countries rose sharply after Donald Trump's victory in November 2016 (*Graph 5*), as financial investors anticipated an acceleration in activity in the United States, which they expected to be boosted by an expansionary fiscal policy. At the beginning of 2017 the various indices (DAX, ICAC, Nikkei and Footsie 100) are however tending to stabilise, except in the United States where the S&P continues to rise.

The volatility of these indices increased a little with the American elections, but has fallen back since then. They have not reached the levels that followed the result of the Brexit referendum, which were themselves relatively low compared to previous shocks.

The dollar rose against the Euro at the end of 2016

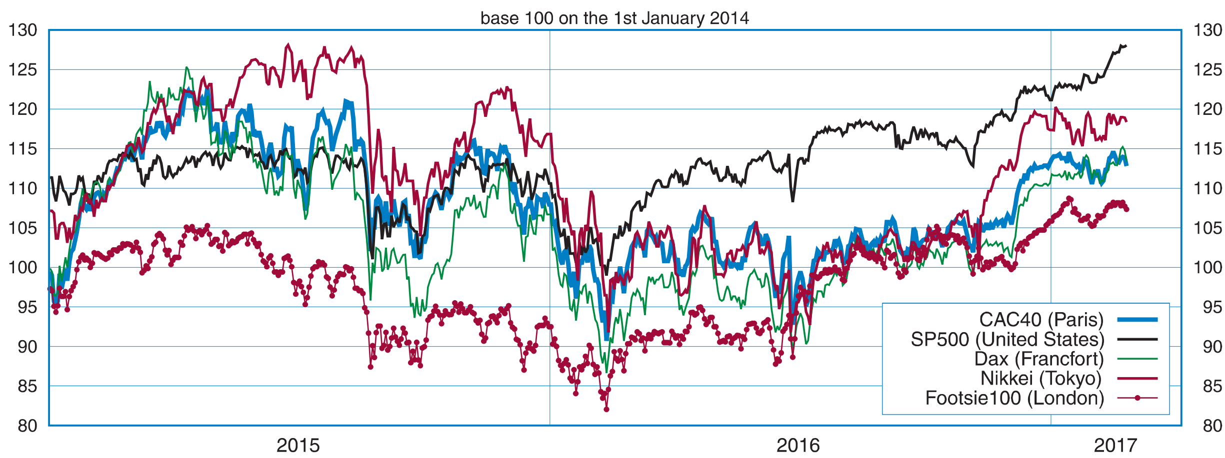
The election of Donald Trump and the rise in the Fed's base rates contributed to the dollar's rise against the Euro at the end of 2016. In

4 - ECB balance sheet and excess liquidity



*Excess liquidity: the banks' deposits with the Central Bank in excess of the minimum reserves.
Source: Macrobond

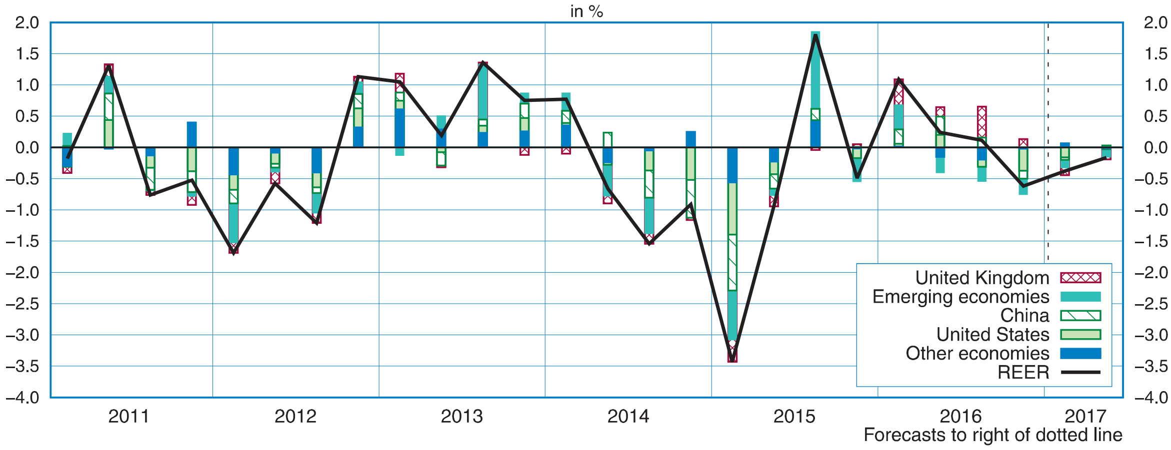
5 - Monthly average volatility of stock market indices of the advanced countries



Source: Macrobond

February 2017, the Euro was trading at 1.06 dollars, compared to 1.12 dollars in summer 2016. This rise has driven that of the emerging currencies that are pegged to the dollar. After the sharp drop in sterling before and after the Brexit referendum, the pound has stabilised at about 0.87 pounds to the Euro. The yen has been fluctuating since December 2016 at around 120 yen to the Euro. All in all, the French real effective exchange rate fell at the end of 2016 (*Graph 6*). By convention, the Euro exchange rate against different currencies is fixed at its last known rate at the beginning of March (1.06 dollars, 0.87 pounds sterling and 120 yen to the Euro) until mid-2017. However, there is uncertainty surrounding Euro-dollar parity, which will depend on the pace at which the Fed raises its base rates. As inflation also remains lower in France than in its main partner countries, the real effective exchange rate is expected to continue falling slightly until June. ■

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



Source: Macrobond, INSEE calculations