Flash Economics

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Abundant global liquidity prevents negative shocks from having major impacts; but global liquidity growth is slowing.

When global liquidity is abundant and growing rapidly, investors continue to buy risky assets, and negative shocks have limited impacts on financial markets. This was the situation observed at the start of 2018. But gradually, global liquidity is going to slow down and then stagnate or even decline. This also means that negative shocks gradually will have increasing negative impacts on financial markets.

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The negative shocks of early 2018 had limited negative impacts on financial markets

At the start of 2018, various negative shocks (protectionism, bad news on growth in Europe, geopolitical shocks, political tension in Europe, etc.) led to a **sharp increase in risk perception (Charts 1A and B).**

Chart 1A
Natixis risk perception index

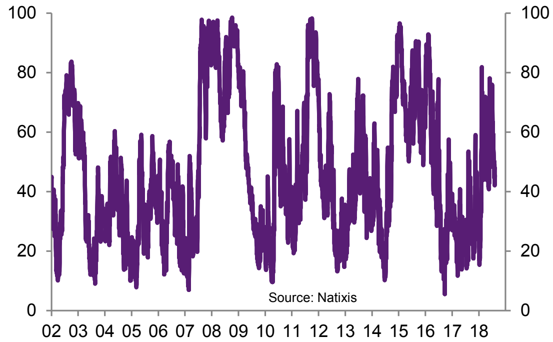
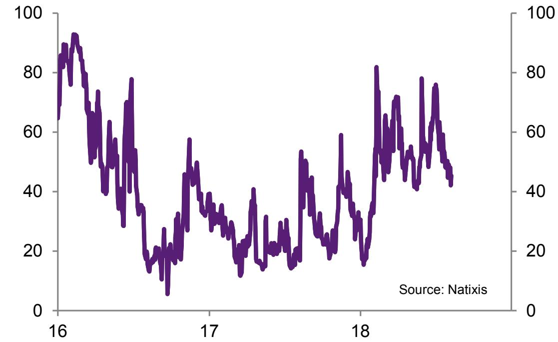


Chart 1B
Natixis risk perception index



However, the negative reaction of financial markets to these negative shocks was limited (Charts 2A and B, 3A, B, C and D, and 4A and B).

Chart 2A
Stock market index (2002:1 = 100)

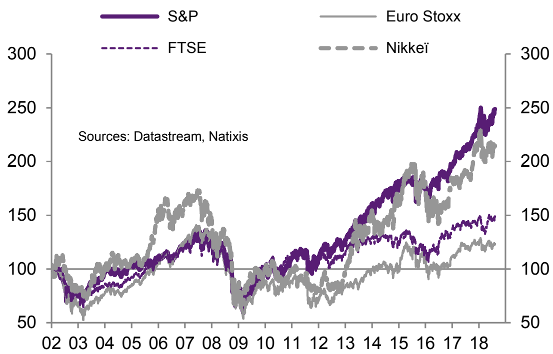


Chart 2B
Stock market index (2016:1 = 100)

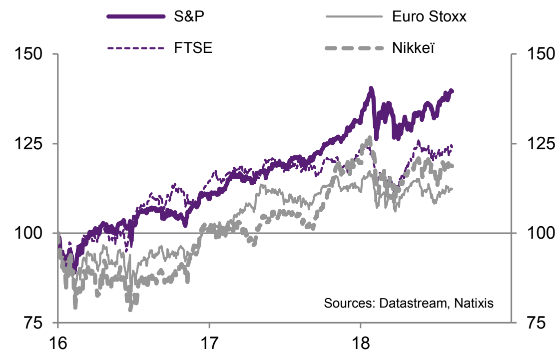


Chart 3A
Investment Grade credit spread*
(asset swaps, in bp)

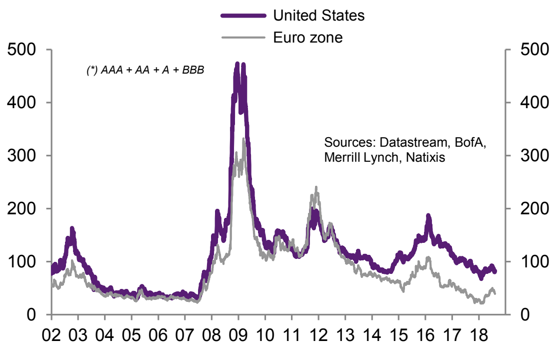


Chart 3B
High Yield credit spread (asset swaps, in bp)

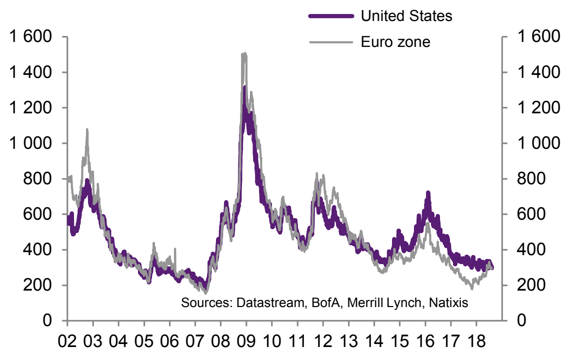


Chart 3C
Investment Grade credit spread*
(asset swaps, in bp)

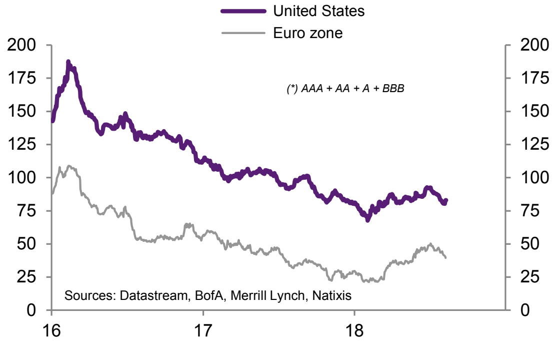


Chart 3D
High Yield credit spread (asset swaps, in bp)

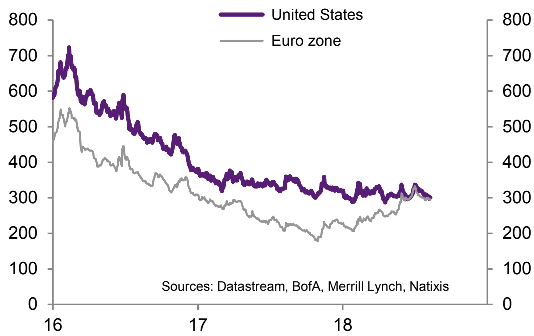


Chart 4A
10-year govt. yield spread against Germany (as %)

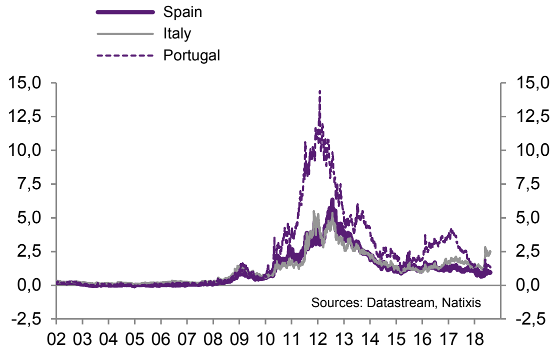
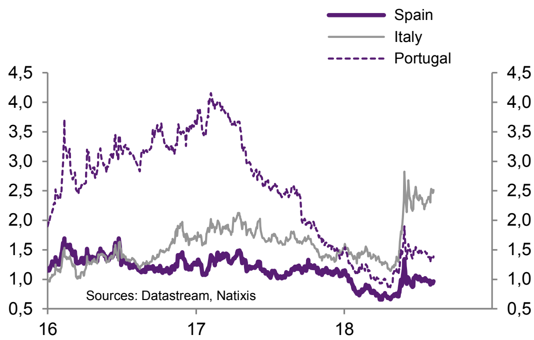


Chart 4B
10-year govt. yield spread against Germany (as %)

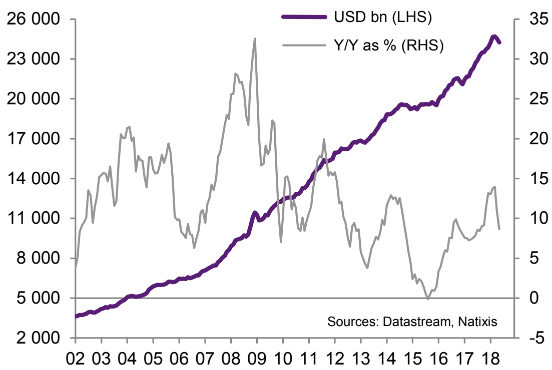


Compared with past crises, the decline in equity markets and the widening of credit spreads and of spreads on euro-zone peripheral bonds remained minor.

Plentiful liquidity plays a major role

Global liquidity (the monetary base) was still growing very rapidly at the start of 2018 (Chart 5).

Chart 5
World: Monetary base

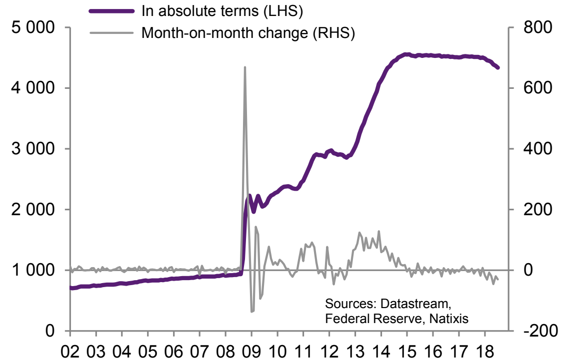


This could account for financial markets' feeble negative reaction to negative shocks. When liquidity (central-bank money) increases, investors who receive this liquidity mostly by selling government bonds to the central bank have to reinvest this liquidity in risky assets, and this stabilises risky asset markets faced with negative shocks.

But global liquidity is set to slow down and even decline due to:

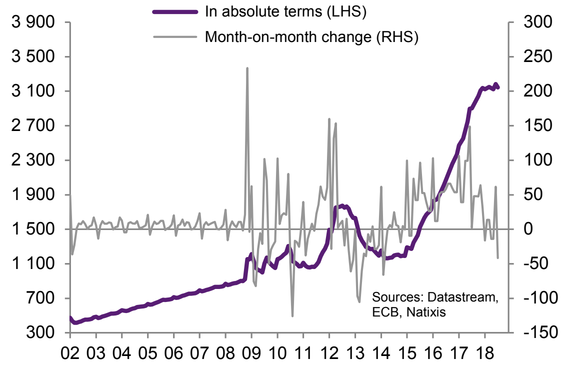
- The reduction in the size of the Federal Reserve's balance sheet **(Chart 6A);**

Chart 6A
United States: Monetary base (USD bn)



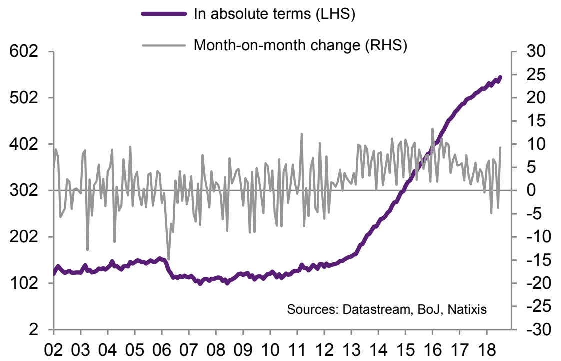
- The termination of the ECB's quantitative easing programme at the end of 2018 **(Chart 6B);**

Chart 6B
Euro zone: Monetary base (in EUR bn)



- A reduction in government bond purchases by the Bank of Japan **(Chart 6C);**

Chart 6C
Japan: Monetary base (in JPY trillion)



- The stagnation of global foreign exchange reserves, especially due to the decline in China's foreign exchange reserves **(Charts 6D** and **E),** because of the disappearance of China's external surplus and the ongoing capital outflows.

Chart 6D
Global foreign exchange reserves (USD bn)

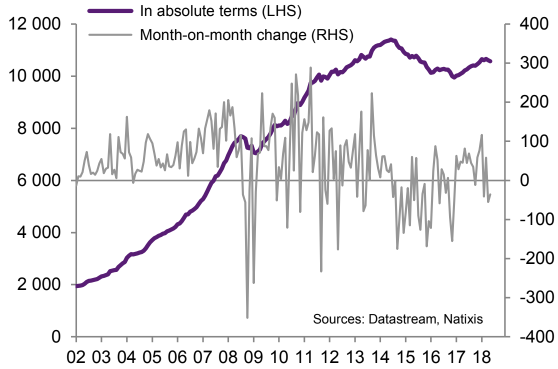
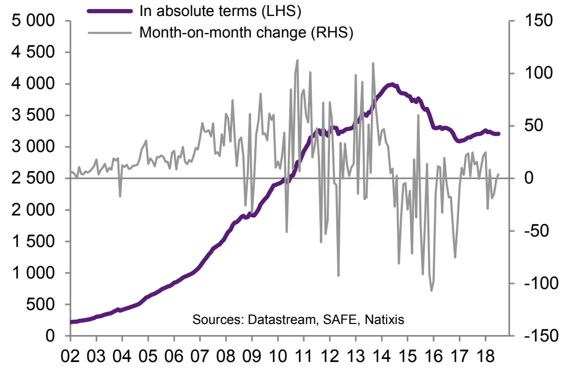


Chart 6E
China: Foreign exchange reserves (USD bn)



Conclusion: A stronger negative impact of negative shocks on financial markets in the future

Negative shocks currently have limited negative impacts on financial markets because of the rapid growth in global liquidity which encourages investors to keep buying risky assets. But global liquidity will gradually slow down and then decrease. This means **that the negative impact of negative shocks on financial markets will also gradually be amplified.**

If risk perception remains high, we can therefore expect an increasing downturn in financial markets over time, due to the slowdown and then decline in global liquidity.

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