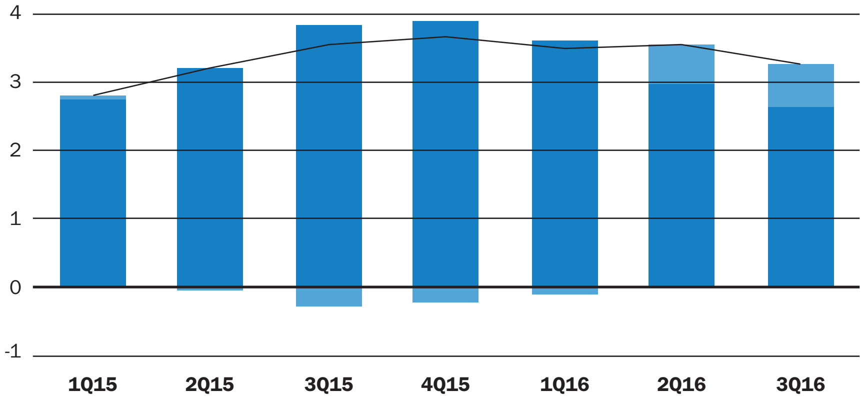


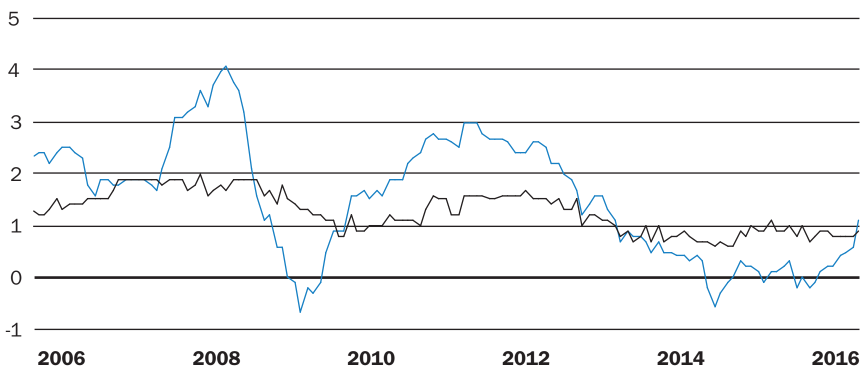
G4 Spain GDP
(year-on-year change and contributions, %)
Source: INE

● Domestic demand
● External demand
● GDP

Monetary policy and financial markets

Inflation remained below the target levels set by monetary policy in the major developed economies. In the Euro area inflation moved back into negative territory early in the year, depressed by falling oil prices. Later in the year it returned to positive territory as oil prices recovered. In the UK the depreciation of sterling on the back of the referendum result put upward pressure on prices. As for the US, core inflation (excluding food and energy) rose to its highest level since 2012 as the amount of slack in the economy was taken up (G5).

As the year began the world's financial markets were severely depressed by low oil prices, unstemmed outflows of capital from China and the uncertainty surrounding the US economy. The situation improved later on as fears of global recession receded, oil prices strengthened, China and the European Central Bank (ECB) adopted measures for monetary easing and the US Federal Reserve took a more accommodative stance. Global markets suffered further sharp movements following the referendum in the United Kingdom at the end of June and Trump's election as president of the United States in November. These events, however, did not threaten to cause any malfunction or loss of liquidity on the financial markets (G6).



G5 Euro area HCPI
(year-on-year change, %)
Source: Eurostat

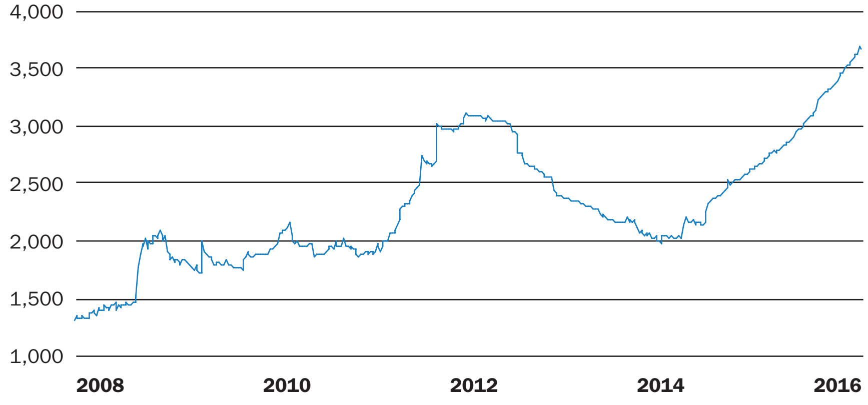
● HCPI
● Core

Central banks in the major developed economies generally maintained an accommodative stance, although a move away from this was initiated in some regions. The ECB was announcing fresh monetary stimulus actions throughout the year. In March it cut its deposit rate to -0.40% and its base rate to 0.00%. In addition, it announced an increase (to €80 billion per month) in its monthly asset purchase programme and the addition of corporate bonds as eligible assets under the programme. In December the ECB announced that the asset purchase programme would be extended from March 2017 until the end of 2017, with a reduction in purchases (to €60 billion) from April onwards. It also made technical changes to the programme to facilitate implementation; these included the possibility of purchasing government bonds yielding below the marginal deposit rate. A further change in 2016 was the introduction of new longer-term financing operations as an incentive to banks to increase lending to the private sector. In the United Kingdom, the Bank of England announced a major stimulus package in August to combat the possible adverse effects of Brexit. In particular, it announced a 0.25% reduction in base rates, a reactivated programme of asset purchases (government and corporate bonds) and a new programme to encourage lending to the real economy. Subsequently, following an upward revision of inflation forecasts, it returned to a neutral stance and stated that monetary policy response could go in either direction. In the US, the Fed increased its benchmark rate in December, raising it to a range of 0.50% to 0.75%, a year after the previous rate increase. In September the Bank of Japan, having set its marginal deposit rate at a negative figure (-0.10%) in January for the first time, announced a major change in the way monetary policy was implemented. In particular, it set a target level in the region of 0.00% for the yield on long-term Japanese government debt (G7).

Long-term government bond yields in the major developed countries remained at low levels. In the course of the year yields sank to record lows. The yield on the German 10-year bond, for example, moved into negative territory for the first time ever. In the first half of the year bond yields were depressed, first by global market turbulence, and then by the uncertainty surrounding the result of the referendum in the United Kingdom. In the case of Germany, the decline in inflation expectations and the ECB's asset purchase programme combined to exert a downward pressure on yields. The summer months were followed by a general upturn in yields, driven by expectations of a rate increase by the Fed, the smaller than expected impact of Brexit, the election of Trump as president of the United States and expectations of a reduction in ECB asset purchases (G8).

Risk premiums in the peripheral European countries ended the year at levels similar to or above those of the year before. Risk premiums were pushed upwards by such factors as financial instability in the first quarter and

G6 Oil price
(dollars per barrel)
Source: Bloomberg

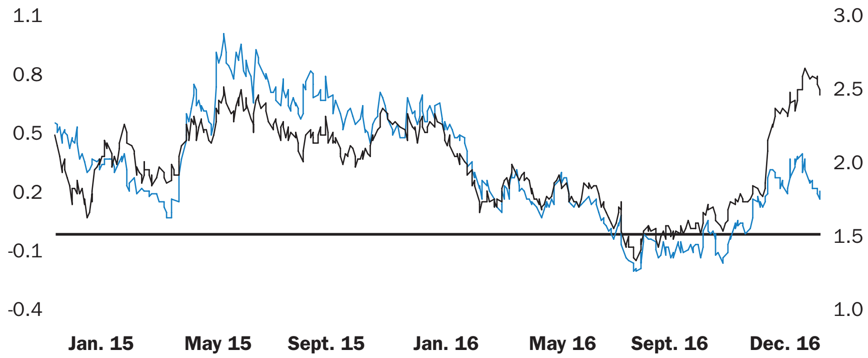


G7 ECB balance sheet
(€ billion)
Source: Bloomberg

the outcome of the US election. There were significant differences among the various countries. Spanish debt, for example, spreads on which hardly increased at all, performed much better than that of Italy or Portugal. The risk premium in Italy was affected by concerns over the country's financial system and uncertainty surrounding the referendum on reforms to the Senate. Portugal's risk premium, apart from being affected by political events and the state of the banking industry, was vulnerable to fears that the DBRS rating agency would remove its investment grade classification from Portuguese government debt (G9).

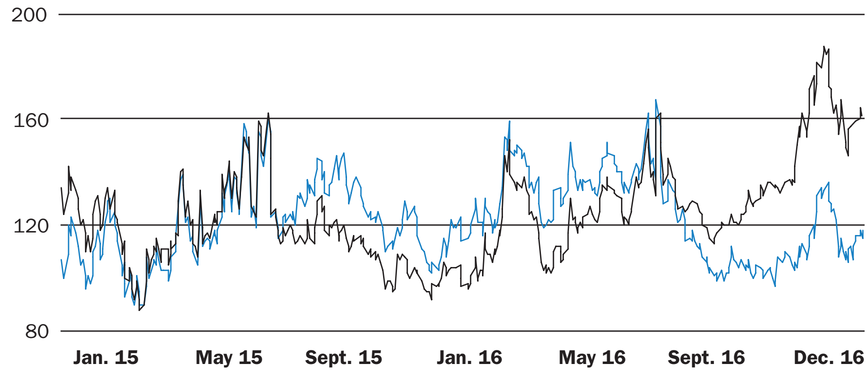
In the emerging economies, financial markets suffered bouts of volatility throughout the year. Emerging market risk premiums, after rising sharply in January and February, fell back and reached levels in August that were the lowest recorded since 2014, against a backdrop of rising global liquidity thanks to monetary easing in the developed countries. In Mexico the markets suffered a major setback as a result of Trump's victory in the US election. Turkish debt was another underperformer in the latter part of the year, as uncertainty grew over the country's political situation and the management of its economy (G10).

On the currency markets, the most significant movement was seen in the pound sterling, which fell sharply against a variety of benchmarks as a result of the uncertainty associated first with the holding, and then with the result, of the referendum on whether the United Kingdom should remain in the EU (G11). Elsewhere, the dollar appreciated against the euro; this is largely accounted for by the dollar's surge in latter part of the year when it found support in growing expectations of rate increases by the Fed (G12). Finally, the yen followed an upward path until



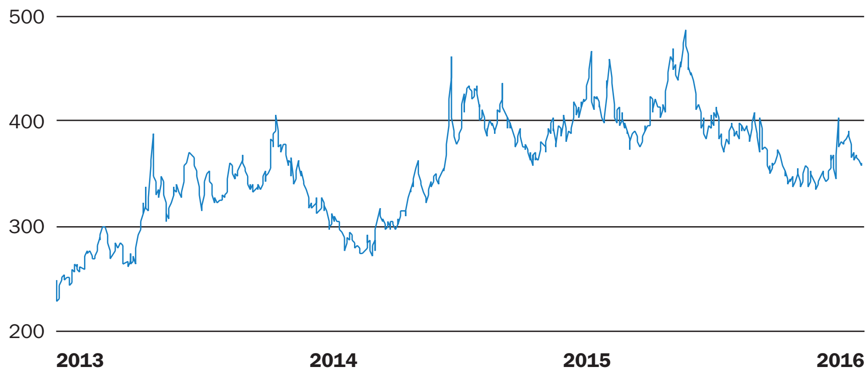
G8 German and US 10-year government bond yields
(%)
Source: Reuters

Germany
USA (right axis)



G9 Risk premium associated with Spanish and Italian 10-year government bonds
(basis points)
Source: Bloomberg

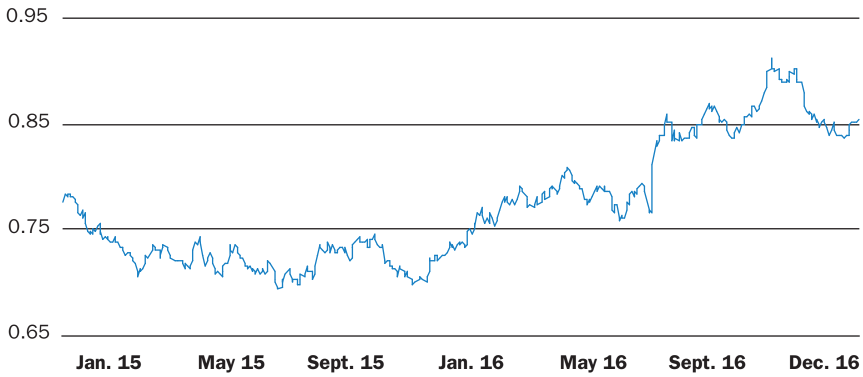
Spain
Italy



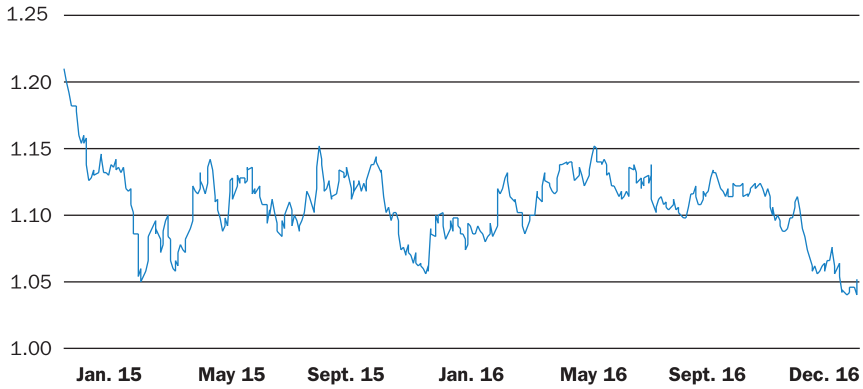
G10 Emerging market risk premium
(EMBI+ index, basis points)
Source: Bloomberg

the summer, supported by financial instability earlier in the year and the heightened uncertainty aroused by Brexit; this despite the setting of negative deposit rates by the Bank of Japan. Towards the end of the year, however, the yen managed to reverse practically all the gains it had made, thanks to the Fed's predisposition to raising its benchmark rate.

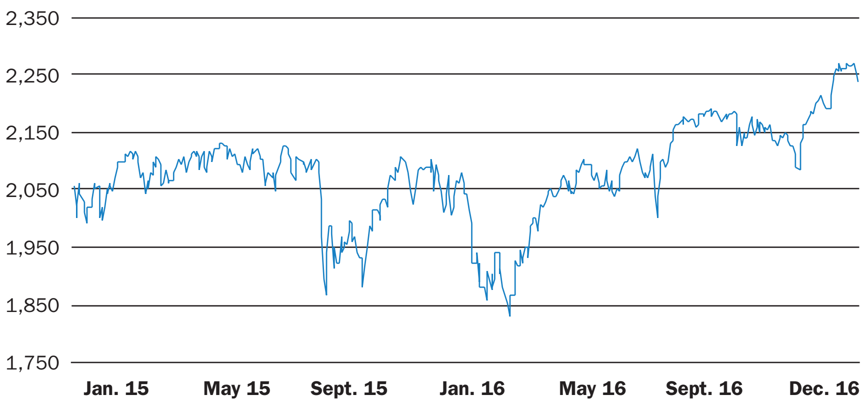
In the equity markets returns in Europe varied widely from one country to another. The gains made by German or French stock indices were in sharp contrast to the falling returns in Spain and, especially, Italy. Generally speaking, after the falls seen early in the year, European stock indices showed no movement in any particular direction apart from the upward movements late in the year. Stock indices were untroubled by events such as the result of the referendum in the United Kingdom. This was helped by ample supplies of liquidity from the main central banks. The S&P index in the US and the FTSE100 in the UK ended the year with significant gains. The British index, however, was down slightly in euro terms as a result of the depreciation of sterling (G13).



G11 Sterling/euro exchange rate
(pounds per euro)
Source: Bloomberg



G12 Dollar/euro exchange rate
(dollars per euro)
Source: Reuters



G13 S&P 500
Source: Reuters