BANCO DE MÉXICO

Executive Summary

Quarterly Report July – September 2018

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Summary

During 2018, Banco de México has conducted its monetary policy in an environment of high uncertainty, which has been generated by global factors and others that are more directly associated to the Mexican economy, and which have gained relatively more importance.

Among the main factors characterizing the external environment are the continuing trade disputes worldwide, specifically between the United States and China, which could even intensify in the future. During most of the reported period, global financial conditions tightened, mainly reflecting expectations of greater-than-previously-anticipated raises in the Federal Reserve's interest rates. As a result, the U.S. dollar appreciated and interest rates increased. However, based on incoming information, a more gradual normalization process is anticipated by markets, although the risk of an inflationary surprise that would modify this outlook still cannot be ruled out. In addition, political and geopolitical risks persist, and other factors of uncertainty have emerged, such as financial difficulties in some emerging economies and the corresponding risk of contagion. The factors described above led to bouts of volatility in financial markets and to a negative performance of emerging economies' asset prices, albeit with differences according to their macroeconomic fundamentals and idiosyncratic factors.

With respect to the factors that directly affect the Mexican economy, in the reported period uncertainty regarding the future trade relationship among Mexico, the U.S. and Canada decreased, due to both the progress in the negotiation process and the announcement of a new trade agreement in North America. This process, however, has not concluded, since such agreement is still to be ratified by the congresses of the involved countries. Recent events such as the announcement of the New Mexico City International Airport project, uncertainty related to the business model adopted by Pemex, and concerns regarding the incoming administration's policies and some legislative initiatives prompted several rating agencies to downgrade the country's sovereign risk outlook from stable to negative. The Mexican peso depreciated, and risk premia and interest rates increased, especially long-term ones. Thus, the current environment is characterized by important risks that could structurally affect the country's macroeconomic conditions, its growth potential and the economy's price formation process. If this environment persists, so that risk premia remain high and long-term inflation expectations are affected, higher interest rates may be necessary throughout the business cycle.

During the reported period, annual headline inflation increased from an average of 4.57% to 4.91% between the second and the third quarters of 2018. This evolution stemmed partly from the growing trend of non-core inflation up to September, which reflected the higher energy prices, mainly of gasoline and LP gas, which, in turn, mirrored the evolution of their international references, and, in the case of gasoline, a gradual decline in the fiscal stimuli applicable to its domestic prices. As a result, non-core inflation remained high for a long time. Meanwhile, although the cyclical conditions were less tight as compared to the beginning of the year, annual core inflation showed resistance to continue declining during the third quarter of 2018. This was partly due to the indirect effects of higher energy prices on the production costs of some of its components. The annual changes of some items of this index followed an upward trajectory, standing out that of the price subindex of services other than education and housing. Thus, different factors, in addition to the aforementioned indirect ones, also contributed to the persistence of core inflation. Among these are the evolution of the exchange rate, the absence of slack and the development of real wages. In this way, core inflation stopped declining and remained practically constant at levels above the target. In particular, annual core inflation shifted from 3.67 to 3.64% in the reference quarters, and lied at 3.63% in the first half of November.

In this sense, the results of the Box *Indirect Effects of Energy Price Increments on Core Inflation* suggest the following:

- The indirect effects have been greater due to the liberalization of gasoline and LP gas prices, which took place in early 2017.

- Annual core inflation's resistance to continue to decline since July 2018 has been associated in part to the referred indirect effects.
- In addition to the referred indirect effects, the exchange rate performance and the evolution of wages also seem to have affected the upward trajectory of the annual change of the price subindex of services other than education and housing.

Annual headline inflation decreased in October and during the first half of November, when it located at a level of 4.56%. This is largely attributed to the decline in annual non-core inflation, as a result of the recent price decreases in LP gas, along with lower price increments of gasoline and electricity fares, as compared to the same period of last year.

In the context described, during the period analyzed in this Report, Banco de México conducted its monetary policy seeking to preserve the anchoring of inflation expectations and to foster the downward trend of annual headline inflation to its target. In particular, in its August and October 2018 meetings the Governing Board decided to maintain the target for the overnight interbank interest rate at 7.75%. The Board noted a certain loosening of slack conditions with respect to those observed in the first quarter of the year, and stressed the transitory nature of the shocks that affected inflation and expectations of a downward trend in core inflation, although it also emphasized the risks and the uncertainty regarding the anticipated trajectory of inflation. However, in its November meeting, the Governing Board raised the target for the overnight interbank interest rate by 25 basis points, upon considering that the balance of risks to inflation had deteriorated considerably and is still biased to the upside in both the short and long terms. In addition to non-core inflation remaining high and core inflation showing a resistance to decline, the fact that the price formation process may be structurally affected by the implementation of different policies was also considered as a risk.

Banco de México's monetary policy stance was determined in an environment in which the world economy grew at a more moderate rate in the third quarter, in a context of a persistent divergence in the economic performance of different regions and countries. In particular, although the U.S. economy continued to grow at high rates, it was below second quarter figures, while other advanced economies grew below expectations and emerging economies continued to weaken. In this environment, global inflation moderated its upward trend, in a context of persistent divergence across countries.

Regarding the evolution of the exchange rate, three episodes can be distinguished. First, from the end of June to early August, the volatility of the Mexican peso decreased and it appreciated by 7.4% as it shifted from approximately USD/MXN 19.92 to 18.45. Some of the factors that contributed to these results are: i) the effects of Banco de México's monetary policy actions; ii) the perception of an improvement in the negotiations of the trade treaty with Canada and the U.S.; iii) the lesser uncertainty after the presidential elections in Mexico; and, iv) at that moment, a widespread weakening of the U.S. dollar. Subsequently, the volatility of the Mexican peso increased, and from mid-August to mid-October the peso fluctuated in a range from USD/MXN 18.50 and 19.40. The above took place in an international environment in which emerging economies' currencies were subject to pressures, largely due to: a) financial difficulties in economies like Turkey and Argentina; b) stronger trade disputes between China and the United States; and c) the possibility that the Federal Reserve will raise the federal funds rate at a faster pace in light of an unexpected upturn in inflation, which generated increments in interest rates for all terms in the U.S. As for this development, it stands out that the Mexican peso showed more resilience as compared to other emerging economies' currencies, which stemmed, among other factors, from the progress in the North American trade negotiations, which led to the announcement of a new trade treaty in the region. Finally, since mid-October, the Mexican peso was negatively affected and its volatility increased once more, mainly due to idiosyncratic factors related to the business model to be adopted by Pemex, the announcement regarding the intended cancellation of the New Mexico City Airport Project and its possible repercussions on public finances and, in general, market concerns regarding the incoming administration's policies and some legislative initiatives. This led several rating

agencies to downgrade the sovereign risk outlook of Mexico and Pemex from stable to negative.

These events are described in this Report in Box *Recent Changes in the Credit Outlook for Mexico and Pemex*, which, in addition to listing the reasons behind the rating agencies' adjustments, it mentions the comments given by other agencies that did not make an adjustment, but which express concern regarding the credit rating outlook for Mexico and Pemex.

The exchange rate depreciated sharply by approximately 8.4% between the third week of October and end-November, locating at about USD/MXN 20.50. It should be stressed that uncertainty persists concerning the policies to be implemented by the incoming administration as well as their implications, in particular, regarding different details that could affect investors' confidence and the country's economic performance. Therefore, new episodes cannot be ruled out in which the Mexican peso can be subject to additional pressures prompting a greater depreciation and in which domestic financial markets exhibit high volatility.

As for the evolution of interest rates in Mexico, two episodes stand out during the reference period. First, between the end of July and mid-October interest rates registered moderate increments in instruments with terms of one year and above, in line with the important increments observed in external interest rates, while short-term ones remained unchanged. Thus, the slope of the yield curve (defined as the difference between 10-year and 3-month interest rates) increased by around 40 basis points in this period. Subsequently, starting from the second half of October, interest rates have registered widespread and sizeable increases, especially medium- and long-term ones. This development was affected by the aforementioned idiosyncratic factors, and, as a result, the referred increments were above those observed in other emerging economies. This evolution caused the slope of the yield curve to further steepen by around 70 basis points during this time period.

In the third quarter of 2018, economic activity in Mexico rebounded, after having contracted during the period April - June 2018. In particular, manufacturing exports grew at a higher rate vis-à-vis the loss of dynamism exhibited in the second quarter, while private consumption remained on a positive trend. In contrast, investment is anticipated to have contracted once more during the quarter, as a consequence of the negative evolution in both the construction sector and in spending on machinery and equipment during July and August.

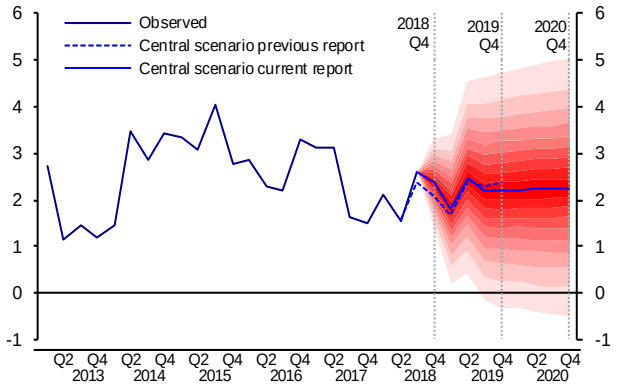
As for the economy's cyclical position, slack conditions are estimated to have tightened slightly as compared to the previous quarter, although they are at less tight levels than those at the beginning of the year.

Banco de México's macroeconomic scenario forecast is as follows:

GDP growth: Forecasts for economic growth in Mexico in 2018 have been modified from an interval of between 2.0 and 2.6% in the previous Report to one of between 2.0 and 2.4%, while for 2019 they have been adjusted from an interval of between 1.8 and 2.8% to one between 1.7 and 2.7%, in both cases based on a larger amount of available information (Charts 1 and 2). For 2020, GDP is expected to grow between 2.0 and 3.0%, which corresponds to the inertial baseline scenario consistent with the potential growth that Mexico has exhibited for several years. In this sense, forecasts for 2019 and 2020 do not consider the impact that the materialization of certain risks described below could have on economic growth. Such forecasts also assume the commitment of the authorities in charge of economic policy to preserve a solid macroeconomic framework in general and sustainable public finances in particular. There is a high degree of uncertainty regarding this outlook, while the Mexican economy is expected to continue facing a complex environment throughout the forecast horizon. Specifically, although the agreement achieved with the U.S. and Canada regarding the trade relationship in the region has reduced one of the risk factors to the Mexican economy to a great extent, there are obstacles for its ratification, in an environment of a possible escalation in global trade disputes and, to a lower extent, the risk of tighter global financial conditions persisting. Domestic elements of uncertainty prevail regarding the different aspects of the economic policy to be implemented by the incoming

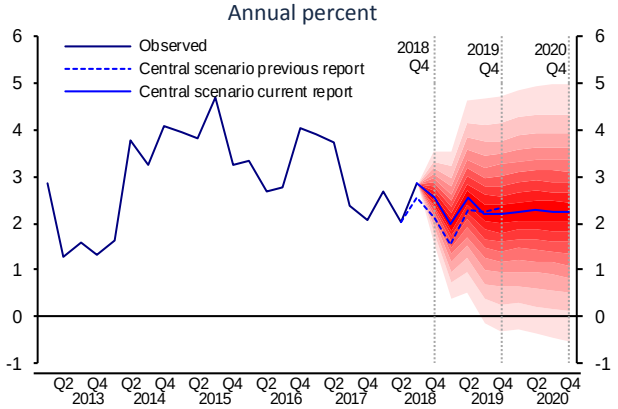
administration and their effects on economic activity and the country's capacity to generate an environment of confidence and certainty conducive to investment.

Chart 1
Fan Chart: GDP Growth, s. a.
Annual percent



s. a. / Seasonally adjusted data.
Source: INEGI and Banco de México.

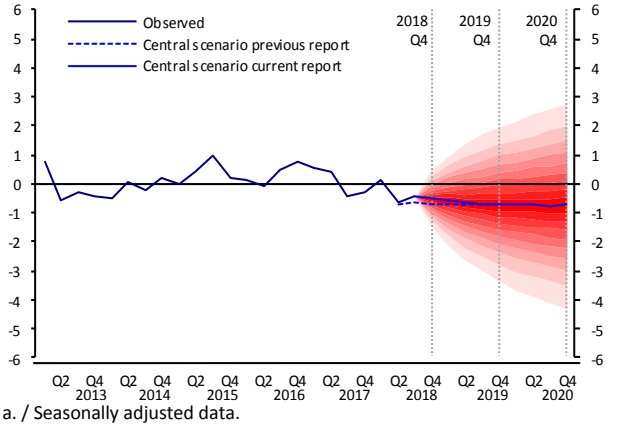
Chart 2
Fan Chart: Growth of GDP Excluding the Oil Sector, s. a.
Annual percent



s. a. / Seasonally adjusted data.
Source: INEGI and Banco de México.

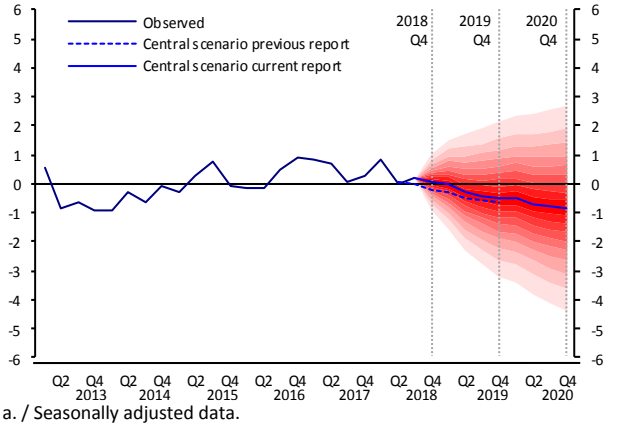
Regarding the economy's cyclical position, slack conditions, measured using the output gap and other general indicators, are estimated to maintain a certain degree of easing throughout the forecast horizon (Charts 3, 4 and 5).

Chart 3
Fan Chart: Output Gap Estimate, s. a.
Percentage of potential output



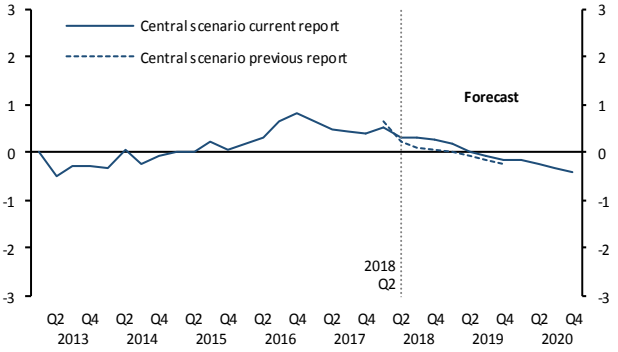
s. a. / Seasonally adjusted data.
Source: Banco de México.

Chart 4
Fan Chart: Output Gap Estimate Excluding the Oil Sector, s. a.
Percentage of potential output



s. a. / Seasonally adjusted data.
Source: Banco de México.

Chart 5
Quarterly Slack Indicator



Notes:
i) The estimated behavior of this indicator is consistent with GDP forecasts excluding the oil sector.
ii) The fan chart for the quarterly slack indicator cannot be estimated due to the nature of this forecast construction.
Source: Banco de México.

Employment: The forecasts for the number of IMSS-insured jobs for 2018 have been adjusted from an interval of between 670 and 770 thousand jobs in the previous Report to between 670 and 740 thousand jobs in this Report, while an interval of between 670 and 770 thousand jobs is still expected for 2019. For 2020, an interval of between 690 and 790 thousand jobs is estimated.

Current Account: For 2018, the deficits of the trade balance and the current account are anticipated to amount to US$ 13.5 and 22.6 billion, respectively (1.1 and 1.9% of GDP), which are below the projections of the previous Report of US$ 13.4 and 23.7 billion, respectively (1.1 and 1.9% of GDP, in the same order). For 2019, the deficits of the trade balance and the current account are estimated to be US$ 14.1 and 28.8 billion, respectively (1.1 and 2.3% of GDP, in the same order), which compare to US$ 14.1 and 27.9 billion, respectively (1.1 and 2.1% of GDP), of the previous Report. For 2020, the trade balance and current account deficits are anticipated to amount to US$ 15.1 and 31.5 billion, respectively (1.1 and 2.3% of GDP, in the same order).

Given the continued uncertainty surrounding the Mexican economy, the balance of risks to growth from a cyclical perspective continues biased to the downside, and is considered to have deteriorated at the margin. Some of the forecast horizon's downward risks are:

i. That the environment of uncertainty that has been affecting investment persists, or even deteriorates, and consequently different businesses postpone or cancel their investment plans in Mexico, or that Mexican consumers cut down on spending as a preemptive measure.

ii. That the ratification and implementation of the trade treaty with the U.S. and Canada is delayed, and the environment of uncertainty that has been affecting investment continues.

iii. That the escalation of protectionist measures at the global level negatively affects global growth, investment and trade, to the detriment of economic activity in Mexico, even if some productive sectors could to a certain degree benefit from the deviation from international trade.

iv. That bouts of volatility in international financial markets are observed, due, among other factors, to inflationary surprises in the U.S. that would lead to higher-than-anticipated interest rate increments in that country, as well as to a possible contagion from other emerging economies, or from geopolitical events that could reduce the sources of financing.

v. That the execution of public spending is delayed given the challenges to implement the public policy agenda associated with the start of a new presidential administration.

Some of the forecast horizon's upward risks to growth are:

i. That the recent announcements of the trade agreement with the U.S. and Canada lead to a notable recovery in investment.

ii. That the greater-than-anticipated dynamism of U.S. industrial production favors Mexican exports.

iii. That a greater-than-expected public spending is registered.

In addition to the above risks, the Mexican economy is facing others that, in case of materializing, could not only affect its cyclical growth, but also negatively impact its potential growth in the medium and long terms. Some of these risks are:

i. That public policy decisions generate greater market concerns, along with a sustained loss of confidence in Mexico as an investment destination that could extend or even aggravate the weakness that investment has been displaying for several years, with the consequent negative effects on the country's productive capacity and on the pace of adoption of new technologies.

ii. That the structural measures aimed at boosting Mexico's productivity are weakened or fail to be implemented.

iii. That the adopted protectionist measures, or the implementation of new ones, negatively impact the participation of certain economies (including Mexico) in the global value chains.

iv. That the competitiveness of the Mexican economy is affected by a number of external and domestic factors, such as corporate tax cuts in the U.S.

v. That public safety issues, corruption, impunity and the lack of rule of law intensify, with their consequent negative impact on investment and economic activity.

Inflation: Regarding the outlook for inflation, in the absence of monetary policy actions, different factors have contributed to delay the convergence of inflation to its target, with respect to the previous Report. Some of these factors are the already observed increases in energy prices, and their indirect effects on core inflation, combined with higher increments than those expected in the services' prices rate of change. As mentioned above, considering these factors, monetary policy was adjusted in November to maintain the convergence of headline inflation to the target in the same horizon as in the previous Report, although over the next quarters headline and core inflation are expected to remain above the previous estimations. Annual headline inflation is, thus, forecast to approach the 3% target in 2019 and remain close to that target during the first half of 2020. The trajectory of annual core inflation was also adjusted upwards for the following months, although, given the monetary policy actions, during the first half of 2020 it is anticipated to attain the same level as that in the previous Report (Table 1, Chart 6 and Chart 7).

Table 1
Headline and Core Inflation Forecast
Annual change in percent

	2018		2019				2020		
	III	IV	I	II	III	IV	I	II	III
CPI									
Current report	4.9 *	4.7	4.4	4.4	3.8	3.4	3.3	3.1	3.0
Previous report	4.8	4.2	3.8	3.6	3.2	3.3	3.2	3.1	
Core									
Current report	3.6 *	3.7	3.6	3.6	3.4	3.1	3.0	2.9	2.7
Previous report	3.6	3.5	3.3	3.2	3.0	2.9	3.0	2.9	

*/ Observed data.
Source: Banco de México and INEGI.

These forecasts are subject to considerable risks. Some of them are:

i. That the Mexican peso remains under pressure due to an environment of higher external interest rates and other external and domestic factors.

ii. That pressures on energy prices or price increases in agricultural products persist.

iii. That there is an escalation of protectionist and compensatory measures worldwide.

iv. That there is a deterioration in public finances.

v. Given the observed shocks and the inflation levels, there is a risk of second-round effects affecting the price formation process.

vi. That wage negotiations are not consistent with productivity gains.

In addition to the above, there are other risks of a structural nature that could be caused by the implementation of policies that lead to major changes in the economy or in the price formation process. In this regard, the following are noteworthy:

i. That the potential growth of the economy declines, given the possibility of a greater weakness of investment and lack of productivity growth.

ii. That a structural weakness of public finances is observed.

iii. That medium- and long-term inflation expectations are revised upwards, in response to a greater persistence of inflation, by affecting the price formation process, associated to changes in the determination of wages and other inputs.

iv. That conditions of access to external financing are affected to a larger extent.

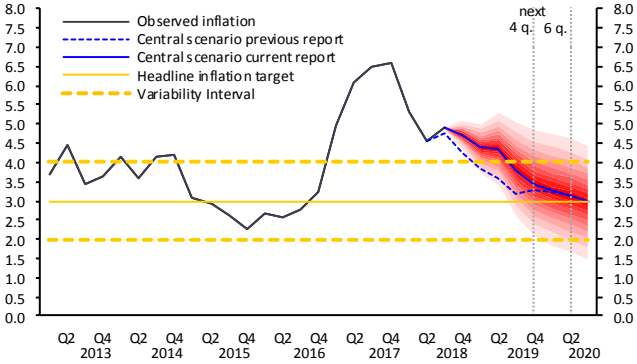
v. Given the materialization of the above risks, that the real exchange rate shows an increasing tendency to depreciate.

Considering the above, the balance of risks vis-à-vis the anticipated trajectory of inflation has deteriorated significantly and is biased strongly to the upside. This takes place in an environment of high uncertainty. In particular, the possibility of adopting actions that could contribute to increase inflation's persistence, by affecting the price formation process through changes in the determination of wages and other inputs, has increased.

The Box *Considerations on Wage Indexation and its Effects on the Economy* included in this Report shows that:

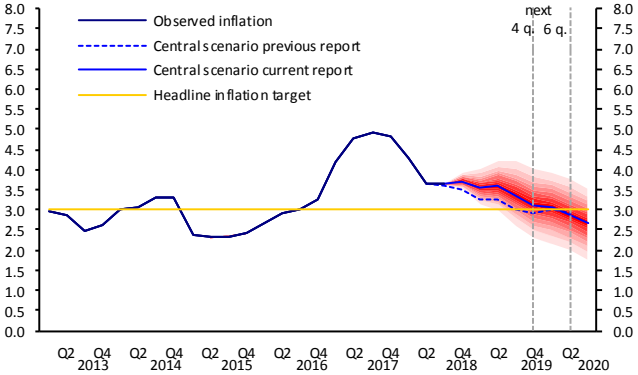
- The possible adoption of formal mechanisms to index nominal wages to observed inflation, by introducing rigidity to real wages, makes it difficult for the economy as a whole to adjust efficiently to negative shocks, thus magnifying its impact on employment and economic activity.
- These mechanisms tend to generate an inflationary spiral between prices and wages, which could lead to a greater persistence of inflation.
- Using econometric exercises, for the case of Mexico, it is shown that in the 80s, when wage indexation mechanisms prevailed, a greater correlation between wage adjustments and inflation was observed, along with a greater persistence of inflation.

Chart 6
Fan Chart: Annual Headline Inflation 1/
In percent



1/ Quarterly average of annual headline inflation. The next four and six quarters are shown starting with the fourth quarter of 2018; i.e., the fourth and second quarter of 2019 and 2020, respectively, timeframe in which the monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

Chart 7
Fan Chart: Annual Core Inflation 1/
In percent



1/ Quarterly average of annual core inflation. The next four and six quarters are shown starting with the fourth quarter of 2018; i.e., the fourth and second quarter of 2019 and 2020, respectively, timeframe in which the monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

To guide its monetary policy actions, the Governing Board follows closely the development of inflation vis-à-vis its anticipated trajectory, taking into account the monetary policy stance adopted and the time frame in which monetary policy operates, as well as available information on all inflation determinants and medium- and long-term inflation expectations, including the balance of risks to such factors. Monetary policy must also respond prudently if for any reason the uncertainty faced by the Mexican economy increases considerably. In the current environment of uncertainty, the Governing Board will follow closely the potential pass-through of exchange rate fluctuations to prices, the monetary policy stance relative to that of the U.S. under an adverse external environment, and the conditions of slack in the Mexican economy. The Board will take the necessary actions, specifically, maintaining or possibly strengthening the current monetary policy stance, so that headline inflation converges to Banco de México's target within monetary policy's period of influence. Similarly, if the complex environment faced by inflation persists or even worsens, higher interest rates would need to be maintained throughout the business cycle. When conducting monetary policy, Banco de México considers at all times its scope and limitations.

In particular, as acknowledged in the Box *Monetary Policy and Economic Activity*, based on the economic analysis and empirical evidence,

changes in monetary policy cannot have a permanent effect on economic activity. Indeed:

- Implementing systematically an expansionary monetary policy to stimulate the economy leads only to increasingly higher inflations without having an impact on the economy's potential growth.
- Therefore, given the costs associated with inflationary episodes, the best way the central bank can contribute to the country's productive activities is to focus on procuring an environment of price stability.

To complement the above, this Report presents another Box *Monetary Policy and Demand for Broad Money,* which shows that:

- Increases in the reference rate have favored greater financial saving by the private sector in long-term instruments and have discouraged holdings of liquid instruments. This has been mainly perceived in greater financial saving by households.
- Thus, by encouraging domestic financial saving, a tighter monetary policy stance has contributed to mitigate the effects of the tighter external financing faced by the Mexican economy.

Although the agreement reached on the renegotiation of the North American trade relationship implies the modernization of certain sectors, while also imposing greater frictions in other, there is no doubt that, despite the persisting obstacles to ratify it, after its announcement the uncertainty related with one of the factors that had been negatively affecting investment in Mexico has decreased. In particular, the fact that the region's economic integration is maintained –and, looking forward, deepens further– should lead to a recovery of investment in Mexico, fueled by projects that had been postponed due to the uncertainty surrounding the trade policy and new business opportunities. However, progress in trade-related matters might not be sufficient to increase, or even maintain, the necessary confidence to trigger greater levels of investment and growth in Mexico if the economy's fundamentals are not shielded and the obstacles that have prevented the country from attaining a higher potential growth are not addressed. It is therefore necessary to maintain and strengthen a macroeconomic framework that prioritizes fiscal discipline and price stability, reinforcing the transparency and accountability of public policies. Structural and institutional problems that discourage investment and hinder productivity growth must also be corrected, keeping in mind that the only way to generate better-paid jobs is through higher productivity.

In this regard, the present Report includes two boxes that explore in depth the relationship between sound institutions, productivity and economic growth.

The first of these boxes *Economic Growth and Productivity*, shows that:

- Although the Mexican economy has continued to expand, its growth rate has been insufficient to address the population's needs. This has been attributed to the poor performance of productivity during several years.
- In order to transit to a path of higher growth, Mexico must:
  - ✓ Maintain those factors that have supported economic activity in the last decades, such as macroeconomic stability, trade liberalization, and the different reforms that have opened different sectors of the economy to greater competition.
  - ✓ Strengthen the institutional framework, in particular, property rights and legal certainty, so that there are incentives and private efforts leading to an improved social well-being.

In the second Box We*ak Rule of Law and Insecurity as Obstacles to Mexico's Growth*, the factors of the institutional arrangement that represent an obstacle for higher economic growth are analyzed in detail. The box shows that:

- The lack of solid institutions and the weak rule of law, together with insecurity problems, are factors that hinder Mexico's growth.
- Weaker rule of law and public institutions could impede the boost in economic activity and investment from being reflected in higher levels of growth and welfare.

- For this reason, sound policies must be adopted to fight insecurity, guarantee full respect for private property and generate an environment of certainty and for the rule of law to prevail.

The aforementioned, besides having a direct impact on the population's well-being, will allow to create an environment of confidence favorable for investment and growth.

Indeed, conditions of increased competition among the different sectors of the economy should be fostered, and incentives that favor value creation rather than rent extraction should be generated. Similarly, investment in infrastructure is needed, as it allows the country to strengthen its domestic market and to further exploit the country's export vocation. As mentioned in previous Quarterly Reports, adequate policies should be implemented in areas other than the economy to fight public insecurity and corruption, to guarantee full respect for private property, to encourage an environment of certainty for investment and for the rule of law to prevail. This would help to generate an environment more conducive to investment and to the adoption of new technologies, leading to greater growth and welfare.

Annex Calendar of Monetary Policy Decision Press Releases (Monetary Policy Statements), Minutes of the Governing Board's Meetings regarding Monetary Policy Decisions, Quarterly Reports and Financial System Reports in 2019

Calendar for 2019

	Monetary Policy Statements 1/	Minutes of the Governing Board's Meetings regarding Monetary Policy Decisions 2/	Quarterly Reports 3/	Financial System Reports 4/
January				
February	7	21	27	
March	28			
April		11		
May	16	30	29	
June	27			12
July		11		
August	15	29	28	
September	26			
October		10		
November	14	28	27	
December	19 5/			4

1/ The Monetary Policy Statements will be released on eight dates in 2019. However, as in previous years, should there be extraordinary events that may require the central bank's intervention, Banco de México reserves its right to modify its monetary policy stance at dates different from those previously scheduled. The Monetary Policy Statements will continue to be released on Thursdays, at 1:00 PM (13:00) CST just as in 2018.

2/ The Minutes of the Governing Board's Monetary Policy Decision Meeting will also be released on Thursdays, two weeks after the corresponding Monetary Policy Statement is published.

3/ The Quarterly Report to be published on February 27, 2019 corresponds to the fourth quarter of 2018; the one to be released on May 29, 2019, to the first quarter of 2019; the one to be released on August 28, 2018, to the second quarter of 2019, and finally the one to be presented on November 27, 2018, to the third quarter of 2019.

4/ Starting from this Quarterly Report, the calendar will include the release dates of the Financial System Report.

5/ The Minutes of the Governing Board's Monetary Policy Decision Meeting of December will be released on Thursday, January 2, 2020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