

## Penalties in EBA stress tests for high ECB funding

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### Summary

**Penalties for banks reliant on ECB funding to be considered in stress tests**, the FT says. The EBA would mark down the banks that use LTRO liquidity by comparing LTRO's low financing costs with actual market funding rates.

Comment: the proposal risks colliding with ECB's intention to offer another LTRO to maintain ample liquidity in the weakest parts of the euro area banking system.

### ECB's Asmussen argues in favour of concomitant start for SSM and SRM.

On OMT, he reminds investors that it was aimed to "counter unjustified fears about a breakup of the euro zone, rather than justified concerns about the functional capability of a political system".

**ECB's Praet says aware of risks of excessively generous liquidity provision**, as bears the risk of reducing incentives for banks to restructure balance sheets".

**Germany – Future of FinMin Schaeuble remains unclear.** Handelsblatt reports that SPD budget politician Kahrs has claimed the Finance Ministry for his party, but SPD said this is not the party position.

**Italian banks problems won't be overcome quickly**, Bank of Italy governor says, stressing the fragile liquidity position, high sovereign exposure and deteriorating asset quality.

**Spain – Average unemployment benefit to fall in 2014**, to €877 from €890 in 2013, due to increasing share of long-term unemployed and lower unemployment subsidy (after exhaustion of unemployment benefit).

Dutch central bank sees risk to economic recovery from domestic political situation.

**Greece – budget draft foresees fiscal deficit falling to 2.4% of GDP in 2014**, primary surplus of 1.6% of GDP, with Greek GDP seen growing by 0.6% in 2014. Deputy FinMin Staikouras said Greece aims at returning to market financing in H2 2014.

**Portugal may use €6.4bn of unused bank recap funds for government financing**, to increase the liquidity buffers ahead of the end of the current bailout programme (in June 2014).

**German exports rebound by 1.0% MM in August**, reversing July drop. French business sentiment stable in Sept, after four consecutive gains. Spanish IP rose by 0.6% MM in August, after falling by 0.4% in July.

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Economics

Western Europe

Industrialised G7 Countries

### Recent Research

#### Euro Economics Weekly — Italy – Political and Banking Fragility

##### Western Europe

The fracture that emerged this week within Italy's PdL party has probably taken the balance of power in the government away from Mr Berlusconi and has increased the chances of some better fiscal outcomes. But the government will remain fragile and unlikely to last until 2015, in our view.

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#### UK Economics Weekly — Fiscal Red Ink Receding

The last few years have seen repeated fiscal disappointments, with the OBR time after time revising up the outlook for the fiscal deficit and public debts. Now, however, fiscal trends seem to be improving and further improvements probably lie ahead. Recent data point to an undershoot of perhaps £10bn or so in this year's deficit. Next year's fiscal deficit is set to fall further (ie at least £10bn) below the OBR's forecasts as

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## Today's News in Detail

**Penalties for banks reliant on ECB funding considered in stress tests.** The FT reports that the European Banking Association (EBA) is considering giving a special attention to the reliance of European lenders on ECB's long-term funding (LTRO) in the upcoming stress tests. The proposal would reportedly see the EBA marking down any bank that uses LTRO liquidity by comparing the LTRO's low financing costs with the real market funding rates the bank would otherwise have to pay. The rationale is that banks highly reliant on ECB cheap funding would face a "cliff risk" at the end of 2014-early 2015, when the current LTROs expire. The plan to introduce this criterion in the stress tests, the FT says, would collide with the ECB's intention to offer another round of LTRO to offset the recent reduction in excess liquidity. The FT argues that the ECB could extend the existing LTRO loans in order to reduce "cliff risk" of banks shifting from ECB financing to more expensive market sources. Comment: new criteria to be used in the 2014 EBA stress tests are still being debated and this proposal may actually not make it to the final list. But if it does, this will indeed collide with the ECB's intention to offer another round of LTROs to maintain ample liquidity in the weakest parts of the euro area banking system.

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**ECB's Asmussen argues in favour of concomitant start for SSM and SRM –** In written answers to Reuters questions, ECB Executive Board Member Joerg Asmussen indicated that the most pressing decision now was to agree by December on a common mechanism to wind down or restore ailing euro zone banks and stressed that *"without doubt it is preferable for the common European supervision (SSM) and the common European resolution (SRM) to start roughly at the same time."* Mr. Asmussen indicated that he believed the timetable to be *"ambitious, but manageable"*. Mr. Asmussen added that the OMT programme was still ready to be activated if needed, but reminded investors that it was aimed to *"counter unjustified fears about a breakup of the euro zone, rather than justified concerns about the functional capability of a political system"*. Mr. Asmussen referred to Italy and said that it does not qualify for the OMT programme so far, while the country needs to tackle low-growth potential and to continue with budget consolidation. Comment: a lot of attention is being placed on the SSM and SRM, the twin pillars of banking union, with the subject likely to be one of the main topics of discussion at the IMF/World Bank meetings this week in Washington. On the OMT, without the necessary set of pre-conditions, one of which being that a member states makes a request of financial assistance to the ESM, the ECB will likely remain on the sidelines. We doubt that the current spread levels would incorporate a sufficiently elevated risk of currency redenomination to justify any intervention.

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**ECB's Praet says aware of risks of excessively generous liquidity provision** - ECB Executive Board Peter Praet said on Monday in a conference speech in Brussels that *"bold monetary policy measures may be effective in the short run, but they also bear the risk of reducing incentives for banks to restructure balance sheets"*. Comment: the ECB's two three-year LTROs were partly designed to counteract the risk of disorderly deleveraging morphing into an acute credit crunch that would likely have had more negative consequences for the economy and risked exacerbating inflation undershooting the ECB's less but close to 2% objective even more. Given the moral hazard issues surrounding the unlimited provision of liquidity over a long period of time, the ECB is understandably reluctant to commit to unveiling another LTRO too early. We continue to believe

the strong economic recovery boosts revenues.

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## UK — In Defence of "Help to Buy"

### Western Europe

The second phase of the "Help to Buy" scheme -- the mortgage guarantee scheme -- starts today. The scheme faces widespread criticism on the grounds that it is an artificial stimulus that it will make homes more unaffordable, may fuel a housing bubble, and that the real problem is low housing supply rather than low demand. We are more supportive of HTB (we stress that our firm is not a mortgage lender in the UK).

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## UK — RICS Survey Shows Buoyant Housing Market

### Western Europe

The RICS survey gives further signs that the housing market is recovering strongly, with buoyant readings for prices and sales across all regions of the UK. The overall net balance of surveyors reporting rising house prices increased to +54% in September from +41% in August and the latest figure is the highest since 2002. This reading probably is consistent with house price gains of more than 10% YoY. .

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## UK — BCC Survey Shows Strong Economic Recovery

### Western Europe

The latest quarterly British Chambers of Commerce (BCC) survey shows widespread strength in new orders and output across manufacturing and services. All this is highly encouraging for the UK's growth prospects and suggests that the economy is finally recovering from the prolonged weakness of recent years. The consensus expects GDP growth of just 2.1% in 2014, but risks seem strongly to the upside.

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## Scandi Economics Update —

### Western Europe

that a two-year fixed rate LTRO facility will be announced in the next three to six months, covering the maturity of the second 3-year LTRO (Feb-15) and the end of the 12-month recapitalisation period that should follow the results of the AQR/EBA exercise around the end of Q3 or early Q4 2014.

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**Germany – Future of FinMin Schaueble remains unclear.** Handelsblatt reports that SPD budget politician Kahrs has claimed the Finance Ministry for his party, but SPD general secretary Nahles said that this was not the party position. The article quotes a political scientist that suggests that FM Schaueble would relinquish the post should the SPD try to claim it as a condition for a coalition agreement. The newspaper speculates that German ECB Executive Board member Asmussen, as SPD member, would be a candidate for the post, but may not be integrated enough into the party and has himself said that he would want to complete his contract at the ECB, which expires in 2019. SPD parliamentary group leader Steinmeier would have higher chances for the post. However, 60% of Germans were happy with Schaueble as FinMin, according to an opinion poll, even though his age (he will be 75 at the end of his parliamentary term) may put some question marks on his continued availability.

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**Germany – Confusion about meeting between CDU, CSU and SPD leaders.** Handelsblatt reports that CSU party head Seehofer announced a meeting with Chancellor Merkel and SPD party head Gabriel for Friday, but such a meeting was not confirmed by any other party official. CDU general secretary Groeche said that informal talks in addition to formal meetings were normal during this period. He also said that he saw room for a compromise on the minimum wage, but also said that he saw a remarkable internal discussion on policy content among the Greens. Meanwhile ECB Executive Board member Asmussen in an interview called for a new German government to be formed quickly for the benefit of Europe. Comment: The story, even if not fully confirmed, still suggests that the coalition negotiations between CDU/CSU and SPD are on track.

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**Germany – Threshold to enter European parliament set at 3%.** Handelsblatt reports that the German President Gauck signed off on a decision by the German parliament to lower the threshold for German parties to enter the European parliament to 3% from 5% previously. The parliamentary decision had followed a ruling by the German Constitutional Court (GCC) in November 2011 that declared the 5% threshold in European Parliament elections unconstitutional. The article notes that even a 3% threshold may not satisfy the GCC.

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**Italy – banks problems won't be overcome quickly,** Bank of Italy governor says. In a report on the Italian banking system Bol Governor, Ignazio Visco, said it is unlikely to see a significant improvement in banks' profitability any time soon, given falling demand for credit and little appetite for saving retail products, leaving cost-cutting as the only way to regain profitability. Visco highlighted the main weaknesses of Italian banks, stressing however that opinions arguing that Italian lenders have "massive capital needs" are unfounded. He cited the recent IMF's stress test results on Italian banks, showing capital needs of €6 to €14bn in the worst-case scenario. Visco said small and medium lenders are in the most difficult position, as they are most dependent on the weak macroeconomic scenario. Visco also warned that the liquidity position of Italian banks rests on the

**Norway** — Norges Bank questions the silence on its feedback on counter-cyclical buffers.

**Norway** — NB launches review of its flexible inflation targeting framework.

**Norway** — Non-socialist government platform: Income tax cuts and new infrastructure fund.

**Norway** — Lower manufacturing output in August.

**Denmark** — Lawmakers agree on new Sifi bank legislation.

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large amount of collateral constituted by government-guaranteed own securities, due to expire in coming years. The governor stressed the large rise in Italian banks' exposure towards the sovereign and the significant deterioration in asset quality (absorbing ¼ of bank profits in H1 13). Separately, ECB funding to Italian banks edged lower to €235bn at the end of Sept, from €241.5bn in Aug, down by around €50bn from the peak of ECB liquidity intake in mid-2012. Comment: the relatively smaller share of ECB liquidity being repaid so far, with exceptionally high, and rising, exposure to the sovereign and with fast-rising non-performing loans, Italian banks are likely to get under the spotlight ahead of the upcoming EBA stress tests.

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**Spain – Average unemployment benefit to fall in 2014** – The secretary of State for Employment, Engracia Hidalgo, said yesterday that the average monthly unemployment benefit will drop to €877 in 2014 from €890 this year (-1.4%), due to the “*exhaustion of unemployment benefits a person could claim after 24 months*”, as well as the reduction on the benefit received after the seventh month of being unemployed (which moved from 60% to 50% of the legal contribution base). The decline is also affected by the reduction in the unemployment subsidy (i.e. amount received after the exhaustion of unemployment benefit) to €426. Comment: while registered unemployment has recently stabilized, the rising share of long-term unemployed means that the negative impact on households' disposable income could be still increasing.

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**Spain - Unemployment still the main concern**, according to the latest CIS barometer, together with corruption, fraud, and the economic situation. El Pais reports the poll which was conducted in September and showed that 89% of respondents believe the economic situation is “*bad*” and “*very bad*” in Spain, while 50% consider it got worse relative to 2012. Unemployment remains the main concern of 77.3% of those polled (although slightly below 80.9% in July 2013), followed by corruption and fraud (37.1%), and the economic situation (32.5%). Despite recent upbeat talks by Spanish politicians, only 20.7% of respondents believe Spain will be better next year. Comment: Unemployment (at 26.3% in Q2 13) is likely to remain the main concern of the Spanish population in the next few years. We expect unemployment to rise to 26.5% in 2013 and to 27.4% in 2014.

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**Dutch central bank sees risk to economic recovery from domestic political situation** – In its semi-annual review of the stability of the Dutch financial sector, Dutch central bank governor Klaus Knot warned that “*the most important risk to the Dutch economy is the political situation. Let's hope that after eight quarters of longing for economic recovery, it is not going to be put at risk because there isn't enough political will to do what is necessary to keep our government finances manageable*”. The Dutch central bank noted that non-performing loan volumes were still rising as a percentage of banks' total assets. It indicated that “*there are signs that Dutch banks are restricting lending in an attempt to strengthen their balance sheets,*” adding that strict credit policies could be lowering credit growth by 2 to 4 percentage points. The report stressed that “*the weak economic recovery remains a risk to further strengthening of balance sheets*”. Comment: although economic activity is expected to recover in the second half of 2013, the Netherlands still need to deliver more in terms of budgetary consolidation over the next few years to reach its medium term objective of closing the structural deficit. The issue of rising NPLs and further challenges facing the construction

sector suggest that the reduced credit availability will constraint economic activity in coming years.

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**Greece – budget draft foresees fiscal deficit falling to 2.4% of GDP in 2014,** debt ratio seen at 174.5%. Presenting the 2014 budget draft, the Greek FinMin said Greece will post a primary surplus of at least €340m (0.2% of GDP) in 2013, before the primary surplus is expected to improve to 1.6% of GDP in 2014. The draft budget also assumes Greek GDP to start growing again in 2014, by 0.6%, on the back of reviving investment and exports. The deputy FinMin Staikouras said Greece aims at returning to market financing in H2 2014. Comment: we think the macroeconomic projections are too optimistic, as an improvement of the primary budget (i.e., net of interest payments) to a surplus of 1.6% of GDP would entail a significant fiscal tightening, which in turn would result in a much lower GDP dynamic. This is true unless sizable fiscal transfers from other euro area countries – like the ECB/Eurosystem profit repatriation measure – will contribute to close the budget gap rather than additional fiscal austerity.

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**Portugal may use €6.4bn of unused bank recap funds for government financing.** Publico newspaper reports that the troika may allow the use of €6.4bn funds (3.9% of GDP) originally devoted to bank recap needs, but so far not withdrawn, to increase the liquidity buffers for 2014, ahead of the end of the current bailout programme. €12bn was originally earmarked for the recapitalization of Portuguese banks. Diario Economico reports that the EU/IMF/ECB troika wants the government to accumulate cash reserves of around €20bn by the end of the current program – a value similar to what Ireland currently has in its coffers, the newspaper says. Comment: the troika and the government are preparing the ground for Portugal to leave the EU/IMF financial lifeline in mid-2014. However, we have doubts that Portugal will be able to return to full market funding next year, and a second bailout programme may eventually be needed.

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**Slovenia – Committees of the National Assembly will start discussion on the government proposal for 2014-2015 budget** (see [Euro Area: Sovereign Debt Crisis Update, 30 September 2013](#)). The final version of the budget has to be delivered to the National Assembly by 7 November. The final version could reflect first shortcomings found by the European Commission by 15 October, while the final version of EC opinion is expected by 15 November, according to Slovenian Press Agency. Separately, today the central bank will publish its new GDP forecast with likely downgrades to 2013 and 2014 growth (current forecasts: -1.9%YY for 2013 and +0.4% for 2014). The government independent IMAD has already revised 2013 GDP growth down to -2.4%YY, to -0.8% in 2014 and +0.4% in 2015. We expect GDP to fall by 2.2% in 2013 and by 0.5% in 2014. The main difference between our forecasts and IMAD's is that we do not fully incorporate the latest banking sector resolution and IMAD assumes a somewhat better outlook for foreign demand in 2014.

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**Germany – exports rebound by 1.0% MM in August,** from -0.8% MM in July. Imports grew by 0.4% MM. All broadly as expected, confirming the July weak trade data have been offset by a rebound in August (probably not just in Germany but in the rest of the euro area as well).



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**France – Sept business sentiment posts another improvement**, fifth consecutive gain, to 98 (Aug: 97). This often overlooked survey has been a better indicator of the underlying momentum in GDP activity in the past few years than the composite PMI or INSEE surveys.

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**Spain – Industrial production rises in August** by 0.6% MM (in line with our forecast), after a decline of 0.4% MM in July. On annual basis, output fell by 2.2% (vs. -1.6% in July), mainly affected by negative base effects. Comment: The result is in line with recent gains in survey indicators (manufacturing PMI stood at 51.1 in August, highest since Mar-11) suggesting a modest rebound in industrial production in 3Q, but still consistent with close-to-zero GDP growth in 3Q. A strong negative base effect from last year pushed the annual rate lower in August, but we expect this to be reversed in September.

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## Latest Issues of Sovereign Debt Crisis Update

### Germany - Grand Coalition Talks Start Well

#### Western Europe

In Germany exploratory talks between CDU and SPD start well. Schaeuble rejects a financial transactions tax (FTT) without a European agreement. French government backtracks on €2.5bn levy on operating profits. Italian Senate committee voted to expel Berlusconi from Senate, as expected. DBRS says recent political turmoil in Italy has not increased the chances of a downgrade. Revaluation of Bank of Italy's shares may help boost Italian banks' capital by €7bn, Reuters reported. Bank of Spain sees risks of missing the deficit target of 6.5%. Swapping Greek bailout loans with a 50-year government bond is being considered, Reuters reports, while Ekathimerini reports that creation of a bad bank is being considered.

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### Portugal's Positive Programme Review

#### Western Europe

Positive troika review sees Portugal returning to full market funding in 2014. ECB's Coeure highlights symmetric inflation target. ECB's Noyer: no need for another LTRO now. Italy's Senate committee votes on Berlusconi's impeachment today. France's INSEE revises up 4Q GDP forecast. Dutch FinMin seeks opposition support for 2014 Budget. Spain's 2014 public debt target ratio revised down. ESM head expects third bailout for Greece. Ireland's 2014 deficit target. Political risk eases in Slovenia.

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### ECB – Under No Pressure to Act

ECB maintains accommodative monetary policy stance. French industry minister calls for minimum wage in Germany. Germany's CDU, Greens meet on Oct 10 for exploratory talks. Berlusconi's U-turn ensures survival of Italian government. Italy's political instability credit negative, says Moody's. Spain's household saving rate edged higher in Q2. Portugal may miss 2013 budget deficit target. Ireland's Sep tax returns on target. Political risk increases in Slovenia.

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## Italian PM Letta Expected to Win Confidence Vote Today

ECB meeting - we expect no change in rates. Berlusconi's PdL close to split, Italian government likely to win confidence vote. DBRS says timely approval of Italian 2014 budget key for rating. Germany's Grand Coalition negotiations could last until 2014. EU calls on Germany and France to do more. France's multi-annual budget programme based on sizeable spending cuts. France mulling changes to planned 2014 VAT cut. Spain's financial programme likely to end in 2013. Slovakia and Slovenia latest.

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## Pressure Rises on Banks' Sovereign Bond Holdings

EBA's Enria and Bundesbank's Weidmann call for regulatory changes to treatment of banks' sovereign bond holdings. Italy: possible split within PdL, Fitch warning on political instability. Germany: Grand Coalition talks begin Friday. Portugal's 2013 debt ratio projection revised higher. Greece: 2014 Budget decisions delayed to end-Oct. Spanish banks further stabilised, say Troika. Spain's 2014 Budget draft handed to Parliament. Ireland: draft forecasts from EC add pressure on Budget negotiations.

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## Italian Political Crisis Intensifies

Italy's governing coalition breaking up, confidence vote expected Wednesday. In Greece, extremist right party Golden Dawn's leaders arrested. Portugal's municipal elections deliver blow to governing coalition. Germany's SPD votes to start coalition talks, plans member referendum. Germany's CDU gains in polls, rejects tax increases. Grand coalition likely after Austrian election. EU Commission welcomes French 2014 budget. Spain's 2014 budget unveiled. Spanish banks to increase provisions.

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## Macroeconomic Forecasts

### European Economic Forecast Highlights — September 2013

#### Western Europe

This companion to Global Economic Outlook and Strategy - September 2013 contains detailed more quarterly forecasts for main European countries to end 2014, as well as annual forecasts to 2017.

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### Global Economic Outlook and Strategy — September 2013

#### Global, Pan Asia, GEMS, Americas, EMEA, Asia, Australia

We have a slight tilt to forecast upgrades this month, and we look for growth of 2.5% in 2013 (up a tenth from last month) and 3.2% in 2014 (unchanged). Over the last six months as a whole, we have raised our 2014 growth forecast for advanced economies by 0.5%, while cutting our 2014 EM forecast by 0.5%. Our forecasts are below consensus in all four BRIC countries. The recovery in advanced economies is unlikely to cause early tightening, given ample slack. .

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### Emerging Markets Macro and Strategy Outlook — Will DM's Recovery Be EM-friendly?

#### GEMS, Asia, CEEMEA, Latin America, Global

Of the EM central banks that have held policy meetings since last week's FOMC, the governors of the two largest - India's and South Africa's - have both emphasized the temporary nature of the relief that emerging economies will

enjoy from the Fed's decision. If that's the case, and if capital flows to EM continue to become scarcer, the market will rely more and more on signs that EM can export its way out of its problems. There is some good news: strengthening export growth from China and Korea in August was part of the story behind the EM rally that we've seen since early September. But we have some reasons to question whether the EM export recovery we'll see will be really robust. This makes us cautious about the economic environment EM is about to enter. While export data seem likely to continue to recover, we think the recovery might be a shallow one, and thus not a reason to discount the growth risks that have plagued EM in the past couple of years.

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# Appendix A-1

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