

## Banking Union Disagreements Continue

Summary | Today's News in Detail | Latest Issues of Sovereign Debt Crisis Update | Macroeconomic Forecasts | Recent Research

### Summary

**German FinMin Schaeuble said the EU Commission could not be both a supporting and winding-up agency for banks** and called for a resolution mechanism applying first to system-relevant banks, but EU Commissioner Barnier disagrees. A legal document warned about legal impediments to transferring bank resolution powers to an agency. Comment: the back and forth continues on the future shape of the banking union, suggesting a resolution mechanism is unlikely to be in place as early as the ECB would like (Jan-15).

**Asmussen says "the ECB is looking at money market rates, especially EONIA, very closely".**

**EBA has not finalised methodological aspects of stress test**, and says no decision has been taken on the treatment of banks' high reliance on LTROs.

**Germany – Bundesbank President rejects permanent supervisory role for ECB**, in order to avoid the risk of making central banks made captives of politics.

**Germany – Green Party** chooses centrist parliamentary group co-leader, possibly signaling reduced chances for a CDU-Green coalition.

**France – government to raise levy on companies with revenues over €250mn to 10.7% from 5% currently**, in order to abandon €2.5bn tax on operating profits.

**Italy – government considers freezing high pensions** in excess of €3,000 per month. Unlikely to produce many savings, but still a positive signal that the government is starting to tackle some of the largest areas of public spending.

**Bank of Portugal - GDP forecasts revised higher to -1.6% in 2013**, from -2.0% in July. But central bank stressed the biggest challenge remains to resume full market access.

**Portugal – PM confirms commitment to fiscal austerity**, with the purpose of boosting market confidence and re-access market funding.

**Greece – key decisions postponed until 2014**, Ekathimerini reports. No debt relief decision before April 2014.

**Greece – banks considering sizeable debt write-offs to deal with NPL**, ahead of key stress tests in December.

**Spain and Ireland – no need for extension of current bailouts**, EU says.

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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

**Banking union disagreements continue** – German Finance Minister Wolfgang Schaueble said on Tuesday that the European Commission could not be both a supporting and winding-up agency for banks, calling for necessary legal steps being required at each point and expressing his preference for a bank resolution mechanism applying first to system-relevant banks, in the same way as the SSM would monitor the largest 130 banks initially. EU Regulation Commissioner Michel Barnier disagreed with Mr. Schaueble, warning that “*small banks can also go bankrupt and in doing so rock the whole system*”, but acknowledged that a compromise must be found between the relevant parties. In an interview with German daily Handelsblatt, he suggested that “*we could agree from the start that the Commission would only take on the task of banking resolution for a limited time*”, indicating that the “*ESM could take over as soon as it has become a European Institution*”, acknowledging that this option would require changes to the European Constitution. On Tuesday, Reuters wrote that a legal opinion from EU lawyers warned that “*only limited powers could be given to an agency to close or salvage troubled banks*”, but supported the idea of giving responsibility to the European Commission or another EU institution rather than an external agency. Comment: the back and forth continues between some member states and the Commission as to who should be responsible for resolution and to what extent supranational decisions would impact national budgets. The problem is significant, given that the new arrangement will need to respect member states' autonomy with respect to spending. The difficulty of the political process suggests that a resolution mechanism is unlikely to be possible as early as the ECB would like (Jan-15).

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**Asmussen on EONIA** – Executive Board Member Joerg Asmussen noted on CNBC TV that “we are looking at money market rates, especially EONIA, very closely”, indicating that the ECB would “keep this in mind and if necessary we can deal with a number of instruments with the liquidity situation for banks” but added that liquidity was “no substitute for lack in capital”. He concluded that it was too early for the ECB to think about exiting its loose monetary policy stance. Comment: This reiterates that interest rates will stay low for a long period of time and that the ECB Governing Council will continue to pay a lot of attention to the transmission of its monetary policy stance through the behaviour of short-end market rates.

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**Modest increase in IMF Eurozone GDP forecasts** - The IMF revised up its 2013 euro area GDP forecast by 0.1ppt to -0.4% but left its 2014 estimate unchanged at 1.0%. For the main euro area countries, most benefited from an upward revision to their 2013 forecasts, with France and Spain gaining 0.3ppt to -1.3% and +0.2%, respectively, and Germany 0.2ppt to 0.5%. For 2014, Germany, France and Spain benefited from a modest 0.1ppt upward revision to 1.4%, 1.0% and 0.2%, respectively. Italy was the only large euro area country whose forecasts were not revised.

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**EBA has not finalised methodological aspects of stress test** - The European Banking Authority (EBA) indicated on Tuesday that it has yet to decide how to deal with lenders it deems to be too reliant on ECB funding. EBA chairman Andrea Enria indicated in an emailed statement that the EBA “*had not yet*

the strong economic recovery boosts revenues.

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## UK — IMF Raises UK Growth Forecast

### Western Europe

In the latest World Economic Outlook (WEO), the IMF has pushed up its UK growth forecasts, and now expects growth of 1.4% in 2013 and 1.9% in 2014, versus 0.7% and 1.5% respectively in the spring WEO (with 0.9% and 1.5% in the IMF's mid-year Article IV Report). The upgrade to the IMF's UK forecast from the spring WEO is the greatest for any advanced economy. In our view, risks to the IMF's higher forecast for the UK are firmly to the upside. .

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## Scandi Economics Update —

### Western Europe

**Sweden** — IMF lowers its 2013 growth forecast a tad.

**Sweden** — Prospera inflation expectations. Monthly inflation expectations among money market players will be released this morning.

**Denmark** — DNB: No room for additional fiscal stimulus.

**Denmark** — IMF cuts near-term growth outlook substantially.

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*discussed the treatment of the LTRO in any future stress test and does not see its role in making assumptions about possible monetary policy actions". Mr. Enria added that "no final decisions on methodological aspects have been made".*

Comment: the EBA and the ECB are going to be cooperating closely throughout the whole exercise that will produce a single capital requirement figure for banks. As a result it is unlikely that institutions over-reliant on ECB liquidity will be treated so harshly as to lead to renewed stress and increased fragmentation, a situation that the ECB has been fighting against for some time.

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**Germany – Bundesbank President rejects permanent supervisory role for ECB.** Handelsblatt reports that Bundesbank President Weidmann on Tuesday said at a convention in Berlin that there are conflicts of interest between monetary policy and financial stability. According to Weidmann, certain provisions could be taken to manage such tensions, but in the long-term it would be desirable to take out the supervisory role of the ECB and assign it to an independent institution. Weidmann also warned not to overburden central banks and to avoid the risk of making central banks captives of politics, noting that liquidity provision by central banks should not be a substitute for recapitalising banks. Comment: Amid the intense ongoing preparations for the upcoming ECB supervisory role, we suspect that President Weidmann's opinion will not resonate among the rest of the ECB Governing Council.

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**Germany – Green Party chooses centrist parliamentary group co-leader.** Handelsblatt reports that the Green Party elected Katrin Goering-Eckhardt, one of the party's two Chancellor candidates in the recent election, as one of its two parliamentary group leaders, representing its centrist wing. Comment: the other candidate for the post, Kerstin Andrae, was generally seen to be more open to a CDU-Green coalition.

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**French corporate taxes** – a ministry official told Reuters that the government will raise the levy on companies with revenues over €250mn to 10.7% from 5% currently, in order to offset lost revenues from abandoning the new €2.5bn tax on operating profit included in the 2014 budget. The 2014 budget goes before the lower house of parliament's finance commission for a first reading today and is unlikely to be voted into law by both houses before December.

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**Italy – government considers freezing high pensions.** The Italian Labour Minister, Enrico Giovannini, announced yesterday the government intends freezing pension benefits for the portion in excess of €3,000 a month. All pensions are currently re-valued annually in line with CPI inflation. According to La Stampa, changes are expected to affect only €34bn out of the total €270bn disbursed for pensions. Giovannini also announced that the government does not intend to modify the pension reform introduced in 2012 ("riforma Fornero"), as additional flexibility on retirement criteria would generate a surge in pension requests and higher pension spending. Comment: the changes are unlikely to produce many savings, given the high ceiling (€3,000) from which they start to apply. However, it is a positive signal that the government is starting to tackle some of the largest areas of public spending – something that it will have to do if it wants to reduce the tax burden. Despite several major reforms to the state-funded pension system in the last 20 years, Italy still shows one of the highest shares of pension expenditure as a percentage of GDP. However, previous

reforms have ensured that pension spending as pct. of GDP has stopped increasing and is on a downtrend in the next 30 years.

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**Italy – fiscal deficit at 2.8% of GDP in Q4 ending in Q2 13, down from 3.0% in Q1.** Government revenues reached a new record high level as a share of GDP at 48.3% (in four quarters ending in Q2), from 47.8% in Q1 13, while primary spending increased from 45.5% of GDP to 45.8%. Primary spending was up by 0.7% YY in Q2, from +0.3% YY in Q1, after contracting by 0.6% in 2012. Interest spending started to show the first signs of retrenchment (-7.0% YY, after growing by 11.2% in 2012), reflecting lower government bond yields since summer 2012. Separately, the Italian treasury reported on Monday monthly data on tax revenues, which showed that YTD in August tax revenues (accrual basis) were roughly flat on 2012 (-0.3% YY), owing to direct tax revenues rising by 2.4% YY (+€3.5bn), only partly offsetting the fall in indirect taxes (-€4.2bn). Higher direct tax revenues mainly stemmed from an improvement in corporate taxes and higher taxes on capital gains and capital incomes. Comment: although they still provide only a partial picture for the annual fiscal dynamics, Q2 government budget data were better than we had anticipated and stand in contrast with a much wider cash-basis central government deficit. The revenue dynamic held up quite well in H1 13, despite the contraction in nominal GDP, resulting in a new record-high level of fiscal pressure. This was the result of the fiscal measures introduced by the previous government, which were focused mainly on increasing tax receipts. On the other hand, it is somewhat worrying that the mild downtrend in primary spending observed in 2011-12 has been inverted. For economic growth to return, Italy should engineer a reduction in fiscal pressure by stepping up the efforts on cutting primary spending. Q2 data suggest the 2013 deficit target of 3% of GDP could be within reach if some tightening measures are adopted in the last months of the year.

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**Italy – bad debts continue to rise quickly by 22.3% YY in August,** Bank of Italy data showed. The ratio of bad loans (“sofferenze”) to total loans edged higher by another tenth in Aug, to 7.3%. It stood at 5.9% in August 2012 and at 3.5% in the five years before the financial crisis. NPL ratio in corporate loans contributed the largest share of the total increase, standing at 11.7% in August, up from 11.3% in July and 8.8% in August 2012. The NPL ratio for households stood at 6.1%.

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**Italy – saving rate edged lower in Q2 for the first time in four quarters,** to 12.7% from 12.9% in Q1. The level of Italian households' saving rate remains low by historical standards (15.7% on average in 1999-2009) as it has been steadily declining to 10.9% during the recent recession. This suggests there is not much room for compressing private savings to boost spending.

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**Bank of Portugal - GDP forecasts revised higher to -1.6% in 2013,** somewhat better than -2.0% expected in July. The Portuguese central bank suggests the economy may be starting to gradually recover and it expects the annual growth rate of GDP to return to positive territory by year-end. It also expects the 2013 fiscal deficit target (5.5% of GDP) to be broadly met, saying that fiscal policy remained restrictive in 2013. The central bank stressed that Portugal faces the big challenge of resuming full access to market funding and this requires credibly

ensuring the continuation of the adjustment effort over the coming years.

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**Portugal – PM confirms commitment to fiscal austerity.** PM Passos said on Tuesday that it is necessary for Portugal to continue reducing the budget deficit in order to stick to the budget goals and regain market confidence in 2014. The PM warned that the austerity measures included in the 2014 budget may risk depressing expectations, similar to what happened in 2011-12. PM Passos also said he sees some form of debt mutualisation eventually in the euro area.

Comment: the commitment to fiscal austerity serves the purpose of trying to regain market confidence, push yields lower and re-access market funding – an arduous target, we argue, given the still large amount of fiscal adjustment to implement and a still rising debt-to-GDP ratio.

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**Greece – key decisions postponed until 2014.** According to Ekathimerini, eurozone policymakers have postponed the decisions on how to plug Greece's funding gap until December and on the type of debt relief until after April 2014. The delay is to allow more time for the discussion on the 2014 Budget – key to determine the size of the funding gap in 2014-15 – and to wait for the results of the upcoming banks' stress tests. The Eurozone official quoted by Ekathimerini said that interesting discussions on Greece are still to be expected in November.

Comment: too many moving parts, including the absence of a German government, are probably forcing a delay of key decisions.

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**Greece – banks considering sizable debt write-offs to deal with NPL.** A senior banking source quoted by Reuters says that Greek lenders will have to cut debts owed by some businesses and households that are unable to recover from six years of recession. NPLs accounted for some 28% of total loans at the end of June and, according to the senior banking source, they are expected to rise in "the mid-30s" next year. Note that in the last few days, media reports had suggested that the major four banks intend to set up bad banks in which to place NPLs. Separately, the Greek central bank governor, Provopoulos, said to Reuters that the stress test's adverse scenario will encompass another 2 years of economic recession and that it is important that the still-available bank recap funds (some €8-9bn, according to the governor) are available as a backstop facility. Comment: a significant round of debt write-off would be a welcome development for the prospects of a Greek recovery, although it would probably require additional official money to be injected into the banks.

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**Spain likely exited recession in Q3 2013, politicians say.** Spanish politicians continue to affirm Q3 2013 marked the end of the Spanish recession. In the Senate, PM Mariano Rajoy said that Spain is exiting recession this quarter, while in a radio interview Economy Minister Luis de Guindos noted that he expects slightly positive growth. This is in line with the Bank of Spain latest estimate of "*a stabilisation or even a slight increase in output in the July-September period*". Separately, the IMF has slightly revised up its growth forecasts for the Spanish economy to -1.3% in 2013 (from -1.6% previously) and to +0.2% in 2014 (from 0%). The unemployment rate, however, is expected to rise to 26.9% at the end of this year, and to fall marginally to 26.7% in 2014. In addition, the IMF expects the general government deficit to fall to 6.7% of GDP in 2013 (vs. official target of 6.5%) and to 5.8% of GDP in 2014 (consistent with the official target). Comment: The IMF predictions for economic growth are consistent with both ours and

official forecasts (of -1.3%) for 2013. We expect, however, that the economy is likely to contract by 0.2% in 2014 (vs. government target of +0.7%), while we expect unemployment to continue rising to 27.4% in 2014.

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#### **Spain and Ireland – no need for extension of current assistance**

**programmes** – Reuters refers to an unnamed EU official saying that neither Spain nor Ireland are likely to seek more financial aid when current financial assistance programmes end later this year. While Spanish authorities see no need to extend the current programme for its banking sector, the Irish government is already funded for 2014 and therefore the country is in “*no in need of financing in the near or medium term*”, Reuters reports. In addition, for Ireland the EU official noted that the country is in “*such a good condition*” that a precautionary programme “*is not necessary*”. Comment: For Spain, €41bn in ESM financial help has been used for bank recap. The facility – which still has ca. €60 still available – will expire on 31 December 2013 and no decision has been taken yet on whether to close it or extend it (probably with some additional conditionality attached) into 2014. In the case of Ireland, the Irish Times reported last month that the government is currently considering a 1-year €10bn precautionary credit line as a safety net to ensure its smooth exit from the bailout programme at the end of this year. We expect that Ireland will agree a precautionary ESM program to extend post-2013, aiming to fund itself fully on the market.

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**Slovenia – may seek external help for its banks**, the central bank governor said on Tuesday, if government bond yields do not fall. Reuters reported that PM Bratusek told parliament that the government budget plans for 2014 and 2015 were designed to enable Slovenia “*to solve our domestic problems at home*”, without asking for international aid.

### **Latest Issues of Sovereign Debt Crisis Update**

#### **Penalties in EBA stress tests for high ECB funding**

##### **Western Europe**

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.

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#### **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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