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Macroeconomic Factors Shaping Foreign Direct Investment Inflows: Evidence from Pakistan

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Abstract
This study endeavors to shed light on the intricate dynamics influencing foreign direct investment (FDI) inflows in Pakistan, with a particular focus on the roles played by inflation, exchange rate uncertainty, gross domestic product (GDP), and the presence of military government. By harnessing annual data spanning from 1991 to 2021 and employing OLS regression analysis, this research seeks to unravel the nuanced relationships among these variables and their impact on FDI inflows. The findings of this study align with expectations, revealing that inflation, exchange rate uncertainty, and GDP exert significant influences on FDI inflows in Pakistan over the study period. These results underscore the importance of macroeconomic stability and economic growth in attracting foreign investment. However, intriguingly, the presence of a military government in Pakistan does not emerge as a significant determinant of FDI inflows according to the empirical analysis. This finding prompts further exploration into the nuanced factors that drive investor perceptions and decisions in the Pakistani context, beyond the political landscape. Overall, the insights gleaned from this study contribute to a deeper understanding of the multifaceted determinants of FDI inflows in Pakistan. By identifying key factors that influence investor behavior, policymakers and stakeholders can develop targeted strategies to enhance Pakistan's attractiveness as a destination for foreign investment, ultimately fostering economic growth and development.
Keywords: Foreign Direct Investment, Inflation, Exchange Rate Uncertainty, Military Government
JEL Codes: F21, F31, O11

1. INTRODUCTION

Attracting foreign direct investment (FDI) is a crucial component of many developing countries' economic development strategies (Te Velde, 2006). FDI can bring in much-needed capital, technology, management expertise, and access to new markets, all of which can contribute to economic growth, job creation, and overall development. To attract FDI, developing countries often undertake various policy measures to create a conducive investment climate. This includes implementing investment-friendly regulations, reducing bureaucratic hurdles, ensuring legal protections for investors, providing incentives such as tax breaks or subsidies, and investing in infrastructure and human capital development. Moreover, developing countries may engage in bilateral or multilateral agreements and partnerships to facilitate FDI inflows (Uttama, 2021). This could involve negotiating trade agreements, investment treaties, or regional economic integration initiatives to enhance market access and investor confidence. Additionally, governments may establish investment promotion agencies (IPAs) to actively promote the country as an attractive investment destination, provide information and assistance to potential investors, and facilitate investment projects from inception to completion. Attracting FDI requires a comprehensive approach that addresses both supply-side factors (such as policy and regulatory frameworks) and demand-side factors (such as market potential and investor perception of risk) (Tavares-Lehmann et al., 2012). By creating an enabling environment for FDI, developing countries can harness the benefits of foreign investment to drive sustainable economic growth and development.

Foreign Direct Investment (FDI) is crucial for the economic development of developing countries, offering opportunities for industrial growth, technology transfer, employment generation, and infrastructure development. However, the flow of FDI varies among developing nations, with some countries attracting significant investments while others struggle to do so. One of the primary determinants of FDI inflows is the economic and political stability of a country. Investors prefer destinations with stable economic conditions and political environments free from instability or conflict (Bayulgen, 2010). Such stability reduces risks and uncertainties associated with long-term investments. Additionally, the quality of infrastructure and institutions plays a significant role. Countries with well-developed infrastructure, including transportation, communication, and energy networks, along with strong institutional frameworks, are more attractive to investors due to lower operational risks and costs. Market size and potential also influence investment decisions. Countries with large and growing consumer bases offer lucrative market opportunities for investors seeking to expand their businesses. Moreover, a favorable policy and regulatory environment is essential. Investment-friendly policies, transparent regulations, tax incentives, and legal protections encourage FDI inflows by providing certainty and security to investors (Adejugbe, 2013). Conversely, bureaucratic hurdles, regulatory uncertainty, and corruption deter investment. Human capital and the labor market are critical factors. Countries with skilled and educated workforces are more likely to attract FDI, as they offer a competitive advantage in terms of productivity and innovation. Moreover, access to finance is crucial for investment and business expansion. Adequate access to credit facilities, venture capital, and capital markets ensures that investors have the financial resources necessary to undertake projects and initiatives. Furthermore, natural

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resources and industry-specific factors influence investment decisions in certain sectors. Endowments of natural resources may attract investments in extractive industries, while proximity to input suppliers or market demand may drive investments in specific sectors. Addressing challenges related to FDI inflows requires comprehensive policy measures aimed at improving the overall investment climate (Te Velde, 2001). This includes enhancing infrastructure, strengthening institutions, promoting human capital development, fostering a conducive business environment, and implementing investor-friendly policies. By addressing these factors, developing countries can attract more FDI inflows and harness their potential for economic growth and development.

FDI serves as a vital catalyst for bridging the investment gap in developing countries, providing avenues for economic advancement through the transfer of advanced technology, infusion of competition, and job creation. Often viewed as the backbone of economies in the developing world, FDI plays a pivotal role in propelling growth both domestically and internationally (Mensah, 2001). By facilitating the transfer of advanced technology and managerial expertise, FDI enables developing countries to upgrade their industrial capabilities and enhance productivity. This transfer of knowledge not only boosts the efficiency of local industries but also fosters innovation and competitiveness in the global marketplace. Moreover, FDI contributes significantly to job creation, offering employment opportunities to the local workforce and stimulating economic activity across various sectors. The influx of foreign investment generates employment both directly, through the establishment of new businesses and expansion of existing ones, and indirectly, through the multiplier effect on related industries and service sectors (Domański, and Gwosdz 2010). Furthermore, FDI serves as a vehicle for integrating developing countries into the global economy, providing access to international markets and facilitating trade and investment linkages. By attracting foreign investors, countries can tap into new markets, diversify their export base, and bolster their competitiveness on the global stage. Recognizing the pivotal role of FDI in driving economic growth and development, policymakers in developing countries are actively pursuing strategies to attract foreign investors. These efforts include implementing investment-friendly policies, streamlining regulatory frameworks, improving infrastructure, and enhancing the overall business environment to create a conducive climate for foreign investment (Kofarbai and Bambale, 2016). In essence, FDI represents a cornerstone of development strategy for developing countries, offering a pathway to prosperity through technology transfer, job creation, and integration into the global economy. As such, fostering an environment conducive to foreign investment remains a top priority for policymakers seeking to unlock the full potential of their economies and promote sustainable development.

Pakistan, like many other developing countries, grapples with numerous challenges hindering its economic progress. Despite efforts to mobilize internal funds and investments, the country often faces limitations in achieving the desired level of economic growth (McKinnon, 2010). In this context, attracting Foreign Direct Investment (FDI) becomes imperative to complement domestic resources and propel economic development.

FDI plays a crucial role in strengthening Pakistan's industrial base by facilitating the infusion of capital, technology, and expertise from foreign investors. Through FDI, the country can leverage advanced production methods, modernize its industrial infrastructure, and enhance productivity across key sectors of the economy. This infusion of foreign capital and know-how not only fosters innovation and efficiency but also positions Pakistan to compete more effectively in the global marketplace. Moreover, FDI holds the potential to catalyze employment generation by creating job opportunities and fostering skills development (Lay and Tafese, 2020). By attracting foreign investors, Pakistan can stimulate economic activity, particularly in sectors with high labor absorption capacity, thereby addressing unemployment and underemployment challenges. Additionally, the transfer of managerial skills and best practices associated with FDI can contribute to the development of a dynamic workforce equipped to meet the demands of a rapidly evolving economy. Furthermore, FDI inflows are instrumental in promoting trade and investment linkages, facilitating technology transfer, and fostering international collaboration. By attracting foreign investors, Pakistan can enhance its integration into global value chains, expand market access for its products, and diversify its export base. This, in turn, can contribute to sustainable economic growth and development, bolstering the country's resilience to external shocks and uncertainties. In light of these considerations, Pakistan's policymakers are actively engaged in efforts to attract and retain FDI by implementing investor-friendly policies, improving the ease of doing business, and addressing structural bottlenecks. By creating an enabling environment for foreign investors, Pakistan seeks to unlock the full potential of FDI as a catalyst for economic transformation, job creation, and sustainable development.

In the context of Pakistan, as in many other developing countries (DCs), Foreign Direct Investment (FDI) holds significant promise as a critical tool for economic development. However, the smooth inflow of FDI into Pakistan faces several hurdles, which necessitate careful consideration by policymakers. In this study, the impact of military government on FDI inflows is examined, taking into account factors such as exchange rate uncertainty, GDP growth rate, and inflation. To comprehensively understand the challenges hindering FDI inflows, it is essential to review existing literature on the subject. By analyzing previous studies and scholarly works, researchers can identify key factors that influence FDI trends in Pakistan (Rizvi et al., 2009). These may include political stability, regulatory environment, infrastructure development, legal framework, and geopolitical factors, among others. By synthesizing insights from the literature, researchers can gain valuable insights into the dynamics of FDI inflows and the role of military government in shaping investment patterns. Subsequently, the study outlines its research methodology, detailing the data sources, analytical techniques, and statistical methods employed to investigate the relationship between military governance and FDI inflows. This may involve econometric modeling, time series analysis, and other quantitative approaches to assess the impact of military rule on investment dynamics.

The empirical findings of the study shed light on the nuanced relationship between military government and FDI inflows in Pakistan (Zahid, 2020). By examining variables such as exchange rate uncertainty, GDP growth rate, and inflation,

researchers aim to elucidate the mechanisms through which military governance influences investor sentiment and capital flows. Interpreting the results within the broader context of Pakistan's economic landscape, policymakers can derive actionable insights to formulate targeted interventions aimed at promoting FDI inflows and fostering sustainable economic growth.

By systematically examining the role of military government in affecting FDI inflows and considering various economic indicators, this study contributes to a deeper understanding of the factors shaping investment patterns in Pakistan. Ultimately, the findings of the study can inform evidence-based policymaking aimed at enhancing the attractiveness of Pakistan as a destination for foreign investment and driving socioeconomic development.

2. LITERATURE REVIEW

Over the past few decades, numerous theories and models have been developed to explain the determinants of Foreign Direct Investment (FDI). Both theoretical and empirical research have contributed to understanding the motivations behind FDI and the establishment of Multinational Corporations (MNCs). Researchers have explored various variables to elucidate the factors driving FDI inflows. For instance, a study conducted by Tcha (1999) in Australia examined the impact of different macroeconomic variables on FDI. The findings revealed that exchange rate fluctuations significantly influenced FDI inflows. This underscores the importance of economic stability and currency dynamics in attracting foreign investment. Similarly, other studies have investigated a wide range of factors that may affect FDI decisions, including market size, labor costs, political stability, infrastructure quality, regulatory environment, technological capabilities, and institutional quality, among others. The significance of these factors may vary across countries and regions, reflecting the diverse economic, social, and political contexts in which FDI operates. Furthermore, theoretical frameworks such as Dunning's OLI (Ownership, Location, Internalization) paradigm and eclectic theory provide a comprehensive understanding of the determinants of FDI. These frameworks highlight the interplay between firm-specific advantages, location-specific advantages, and internalization advantages in shaping FDI decisions.

Research on FDI determinants has contributed valuable insights into the complex dynamics of international investment flows. By identifying the key factors driving FDI and their implications for host countries, policymakers and practitioners can develop strategies to attract and retain foreign investment, fostering economic growth and development. Research on FDI determinants extends beyond Australia to encompass other regions and countries, offering valuable insights into the factors influencing foreign investment decisions. For instance, a study conducted by Yang et al. (2000) in Australia analyzed quarterly data to identify determinants of FDI. Their findings highlighted the significance of interest rates and inflation in shaping FDI inflows, underscoring the importance of monetary policy factors in attracting foreign investment. Similarly, research conducted by Moolman et al. (2006) focused on South Africa and examined FDI determinants using data spanning from 1970 to 2003. Their analysis revealed that exchange rates, market size, and infrastructure quality were significant factors affecting FDI inflows into South Africa. These findings underscore the multifaceted nature of FDI determinants, which encompass economic, institutional, and infrastructural considerations. Policymakers in South Africa can use these insights to formulate strategies aimed at enhancing the country's attractiveness to foreign investors. Moreover, comparative studies, such as the one conducted by Sinha et al., (2007), provide valuable insights into the FDI landscape across different economies. Sinha's analysis compared India and China, revealing differences in their FDI determinants. India was found to be more successful in attracting FDI inflows due to factors such as the availability of human capital, lower political instability, and consistent economic policies compared to China. Such comparative analyses offer valuable lessons for policymakers seeking to optimize their countries' FDI attractiveness and competitiveness in the global market.

The study by Lodhi et al. (2013) sheds light on the significant determinants of FDI in Pakistan, highlighting the positive impact of factors such as electricity production, capital formation, GDP growth, and industrial value addition. These findings underscore the multifaceted nature of FDI inflows, which are influenced by a combination of economic, infrastructural, and policy-related factors. Moreover, the study emphasizes the importance of government policies in attracting both local and foreign investors. By offering incentives such as tax rebates to local investors, the government can stimulate domestic investment, thereby creating a more favorable environment for FDI. However, the study also identifies critical challenges that hinder FDI inflows, namely, the shortage of electricity and the threat of terrorism. Addressing these challenges is paramount for Pakistan to enhance its attractiveness to foreign investors. The government must implement corrective measures to mitigate the impact of electricity shortages and terrorism, thus creating a more stable and conducive environment for investment. By addressing these obstacles, Pakistan can unlock its full potential to attract FDI and drive economic growth and development.

The study by Alam et al., (2011) delves into the significance of FDI for host countries, particularly focusing on a panel of ten OECD member countries. Through their investigation, they identified various potential determinants of FDI, including labor cost, labor productivity, market size, natural resource intensity, external debt, political stability, quality of infrastructure, corruption practices, tax rates, openness, inflation, and real effective exchange rate. Their statistical analysis revealed that these determinants significantly influenced FDI both in the short and long run periods. Specifically, countries with lower labor costs were found to be preferred by investors seeking to reduce production costs. This finding underscores the importance of cost considerations in investment decisions and highlights the competitive advantage that countries with lower labor costs may possess in attracting FDI. By identifying and analyzing these determinants, the study provides valuable insights into the factors that drive FDI inflows in OECD member countries. Policymakers can use this information to formulate strategies aimed at enhancing their countries' attractiveness to foreign investors and promoting sustainable economic growth and development.

Afza & Zeeshan (2012) conducted a comprehensive investigation into the determinants of FDI in Pakistan, considering various factors such as the cost of the war against terrorism, political instability, electricity generation, real GDP growth rate, trade openness, exchange rate stability, and inflation rate. Their study utilized time series data spanning from 1980 to 2010 to analyze the dynamics of FDI inflows over this period. Their statistical analysis, employing both ARMA modeling and ordinary least square regression techniques, revealed several significant findings. Specifically, they found that electricity generation, market size, trade openness, exchange rate stability, and fiscal incentives demonstrated a significant and positive relationship with inflows of foreign direct investment. These results underscore the importance of addressing key factors such as infrastructure development, market size, trade policies, exchange rate stability, and government incentives to attract foreign investors to Pakistan. By focusing on these determinants, policymakers can formulate targeted strategies to enhance Pakistan's attractiveness as a destination for FDI, thereby fostering economic growth and development in the country.

The study by Afza & Zeeshan (2012) made a notable contribution by examining the relationship between previously underexplored variables—such as the cost of war against terrorism, political instability, and electricity generation—and FDI inflows in Pakistan. While the variables for the cost of war against terrorism, political instability, and inflation rate were found to have an insignificant relationship with foreign direct investment, the analysis shed light on their potential impact on FDI inflows. Despite the lack of statistical significance in their relationship with FDI, the study underscores the importance of considering these factors in the broader context of attracting foreign investment. The findings suggest that while these variables may not have demonstrated a significant impact in this particular study, they nevertheless warrant attention from policymakers and researchers due to their potential influence on FDI inflows. By highlighting the relevance of these variables, the study emphasizes the need for further research and policy consideration to better understand their effects on FDI inflows in Pakistan. Addressing issues related to the cost of war against terrorism, political stability, and electricity generation could potentially enhance the country's attractiveness to foreign investors and stimulate greater FDI inflows. This underscores the importance of a holistic approach to fostering an environment conducive to foreign investment and economic development in Pakistan.

The research conducted by Hamid et al., (2013) delved into the relationship between three macroeconomic variables and FDI inflows in Pakistan. By analyzing monthly data from the years 2001 to 2003, the study identified stock market performance and exchange rates as significant determinants of FDI inflow. Specifically, the findings indicated a positive correlation between stock market performance and FDI, while exchange rates were found to have a negative relationship with FDI inflows. Employing multiple regression analysis following an assessment of data stationarity using the ADF test, the study provided valuable insights for policymakers. It underscored the importance of ensuring a peaceful environment, efficient market performance, and stable exchange rates to attract FDI inflows in Pakistan. By addressing these factors, policymakers can create an environment conducive to foreign investment, thereby fostering economic development and growth. The study's findings serve as a valuable resource for policymakers, offering actionable insights into the key determinants of FDI inflows in Pakistan. By focusing on enhancing market efficiency, maintaining exchange rate stability, and promoting a peaceful environment, policymakers can work towards attracting greater levels of FDI, ultimately driving economic progress and prosperity in the country.

3. METHODOLOGY

The study employed annual data collected from various sources including the State Bank of Pakistan (SBP), Economy Watch, and the Federal Bureau of Statistics of Pakistan. To assess the nature of the time series data, the Augmented Dickey-Fuller (ADF) test was applied, and a correlation matrix was calculated to examine the relationships among the predictors. Subsequently, Ordinary Least Squares (OLS) regression was conducted after verifying the assumptions of the model. The model used in the analysis aimed to explore the influence of several hypothesized factors on FDI inflows, as represented by the equation: $FDI=f(Exchange\ Rate,MG,Inflation,GDP)$*FDI=f(Exchange Rate,MG,Inflation,GDP)*

Where:

- $LnFDI$*LnFDI* represents FDI measured as total foreign direct investment in million dollars.
- $Exchange\ Rate$*Exchange Rate* is the ratio of the Pakistani rupee against other currencies.
- $Inflation$*Inflation* denotes the annual inflation rate.
- GDP*GDP* represents the annual GDP growth rate.
- MG*MG* indicates the presence or absence of military government.

By analyzing the relationships between these variables, the study sought to identify the key determinants influencing FDI inflows in Pakistan. Through regression analysis, the researchers aimed to provide insights into how factors such as exchange rates, inflation, GDP growth, and the presence of military government impact FDI, thereby contributing to a better understanding of FDI dynamics in the country.

4. RESULTS AND DISCUSSION

The correlation matrix presented in Table 1 depicts the pairwise correlations among the variables EX_RATE, GDP, INFLATION, and MG. Each cell in the matrix represents the correlation coefficient between the respective pair of variables. The correlation coefficient between EX_RATE and GDP is 0.1623, indicating a weak positive correlation between the exchange rate and GDP. For INFLATION, the correlation coefficients with EX_RATE and GDP are -0.01804 and -0.0144, respectively, suggesting very weak negative correlations with both variables. Notably, the variable MG exhibits more substantial correlations with the other variables. The correlation coefficient between MG and EX_RATE is

-0.3798, indicating a moderate negative correlation between the monetary aggregate (MG) and the exchange rate. Similarly, there is a moderate positive correlation of 0.3507 between MG and GDP. Furthermore, INFLATION and MG have a correlation coefficient of -0.4392, indicating a moderate negative correlation between inflation and the monetary aggregate. Overall, the correlation matrix provides insights into the relationships among the variables, helping to understand their interdependencies and potential associations.

Table1: Correlation matrix

	EX_RATE	GDP	INFLATION	MG
EX_RATE	1			
GDP	0.1623	1		
INFLATION	-0.01804	-0.0144	1	
MG	-0.3798	0.3507	-0.4392	1

The regression results presented in Table 2 demonstrate the relationship between the dependent variable, FDI (Foreign Direct Investment), and several independent variables. The method used for estimation is Least Squares. The coefficient for the constant term (C) is 6.39, with a standard error of 0.54. The t-statistic is 11.80, indicating a significant relationship between the constant and the dependent variable at the 1% level of significance. The coefficient for EX__RATE* (Exchange Rate) is -59.42, with a standard error of 14.25. The t-statistic is -4.16, suggesting a significant negative relationship between the exchange rate and FDI at the 1% level of significance. For GDP (Gross Domestic Product), the coefficient is 0.13, with a standard error of 0.06. The t-statistic is 2.00, indicating a marginally significant positive relationship between GDP and FDI at the 10% level of significance. The coefficient for INFLATION (Inflation) is 0.10, with a standard error of 0.03. The t-statistic is 3.26, showing a significant positive relationship between inflation and FDI at the 1% level of significance. However, the coefficient for MG (Monetary Aggregate) is 0.30, with a standard error of 0.33. The t-statistic is 0.89, suggesting that the relationship between MG and FDI is not statistically significant. The R-squared value is 0.72, indicating that the independent variables collectively explain 72% of the variation in the dependent variable, FDI. The adjusted R-squared, which considers the number of independent variables in the model, is 0.66. The F-statistic is 11.68, with a probability value of 0.0000, suggesting that the overall regression model is statistically significant at conventional levels. The Durbin-Watson statistic is 1.26, which is close to 2, indicating that there is no significant autocorrelation present in the residuals. Overall, the regression results provide insights into the factors influencing foreign direct investment, highlighting the significant impact of exchange rates and inflation on FDI inflows.

Table 2: Regression Results

Dependent Variable: FDI Method: Least Squares				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	6.39	0.54	11.80	0.00
EX__RATE*	-59.42	14.25	-4.16	0.00
GDP***	0.13	0.06	2.00	0.06
INFLATION*	0.10	0.03	3.26	0.00
MG	0.30	0.33	0.89	0.38
R-squared	0.72	Mean dependent var		6.81
Adjusted R-squared	0.66	S.D. dependent var		0.94
F-statistic	11.68	Durbin-Watson stat		1.26
Prob(F-statistic)*	0.0000			

5. CONCLUSIONS

The study investigated the impact of four key macroeconomic variables — GDP, inflation, exchange rate, and the presence of military government (MG) — on the inflow of Foreign Direct Investment (FDI) in Pakistan over the period from 1991 to 2021. By analyzing the relationships between these variables, the researchers aimed to discern the factors influencing FDI dynamics in the country over the long term. Using time series data spanning three decades, the study sought to provide insights into how fluctuations in GDP growth, inflation rates, exchange rate movements, and the political landscape influenced the flow of FDI into Pakistan. Through rigorous statistical analysis, including regression techniques and hypothesis testing, the researchers aimed to uncover the extent to which these macroeconomic factors contributed to variations in FDI inflows during the study period. The study's findings indicate that three out of the four examined macroeconomic variables — GDP, inflation, and exchange rate — exert a significant influence on the inflow of Foreign Direct Investment (FDI) into Pakistan. Specifically, variations in Pakistan's GDP growth, inflation rates, and exchange rate movements were found to correlate with changes in FDI inflows over the study period. However, contrary to expectations, the presence of military government (MG) was not found to have a significant effect on the level of FDI inflow in Pakistan. This suggests that, while political stability and governance structures are often considered important determinants of FDI attractiveness, the specific presence of military government did not appear to significantly impact foreign investment flows into the country during the period under investigation. These findings have implications for policymakers and stakeholders involved in economic development and investment promotion efforts in Pakistan.

Understanding the nuanced relationships between macroeconomic variables and FDI inflows can help policymakers formulate targeted strategies to attract and retain foreign investment, thereby fostering economic growth and development in the country. The examination of the role of military government (MG) on the level of FDI inflow in Pakistan represents a notable contribution to the existing literature on FDI determinants. By shedding light on this previously unexplored aspect, the study provides valuable insights for policymakers, investors, and researchers alike. The findings offer foreign investors a better understanding of the factors influencing FDI inflows into Pakistan, enabling them to make more informed investment decisions. Moreover, the identification of significant macroeconomic determinants such as GDP growth, inflation rates, and exchange rate movements underscores the importance of economic stability and growth prospects in attracting foreign investment. For policymakers, these results highlight the need to focus on fostering favorable economic conditions, such as sustainable GDP growth and stable inflation and exchange rates, to attract greater FDI inflows. While the absence of a significant effect of military government on FDI inflows may indicate a degree of resilience in Pakistan's investment climate, policymakers can still strive to enhance governance structures and political stability to further bolster investor confidence. Overall, the study's findings contribute to the body of knowledge on FDI determinants and provide valuable insights for promoting investment and economic growth in Pakistan.

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